No. 99-1295-CFX Title: David A. Gitlitz, et ux., et al., Petitioners
v.
Commissioner of Internal Revenue

Docketed: February 2, 2000 Court: United States Court of Appeals for the Tenth Circuit

Entry	Date	Proceedings and Orders
	Feb 1 2000	Petition for writ of certiorari filed. (Response due April 3, 2000)
	Feb 25 2000	Order extending time to file response to petition until April 3, 2000.
	Mar 31 2000	Brief of respondent Commissioner of Internal Revenue filed.
	Apr 12 2000	DISTRIBUTED for Conference of April 28, 2000
	Apr 27 2000	Reply brief of petitioners David A. and Louise A. Gitlitz, et al. filed.
	May 1 2000	Petition GRANTED. SET FOR ARGUMENT October 2, 2000. **********
	May 11 2000	Motion of the Solicitor General to dispense with printing the joint appendix filed.
	May 16 2000	Order extending time to file petitioners' brief on the merits to and including June 29, 2000.
	May 22 2000	Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
	Jun 28 2000	Brief amicus curiae of Real Estate Roundtable filed.
	Jun 29 2000	Brief of petitioners David and Louise Gitlitz and Philip and Eleanor Winn filed.
	Jul 24 2000	Record filed.
	Jul 26 2000	CIRCULATED.
	Jul 27 2000	Record filed.
	Aug 2 2000	Brief of respondent Commissioner of Internal Revenue filed.
	Aug 28 2000	Motion of Real Estate Roundtable for leave to participate in oral argument as amicus curiae and for divided argument filed.
	Sep 6 2000	Reply brief of petitioners David A. and Louise A. Gitlitz, et al. filed.
	Sep 25 2000	Motion of Real Estate Roundtable for leave to participate in oral argument as amicus curiae and for divided argument distributed.
	Sep 26 2000	Motion of Real Estate Roundtable for leave to participate in oral argument as amicus curiae and for divided argument DENIED.
	Oct 2 2000	ARGUED.

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No. _____

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in conflict with the holdings of the Third Circuit in *United States v. Farley*, No. 99-3209, ___ F.3d ___ (3d Cir. 2000) (App. 92) and the Fifth Circuit in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 62 F.3d 136 (5th Cir. 1995), *aff'g and adopting the opinion of the Tax Court*, 103 T.C. 398 (1994), the Tenth Circuit incorrectly held that tax attributes subject to reduction under 26 U.S.C. § 108(b), including the suspended losses of an S corporation shareholder, must be reduced in the year that discharge of indebtedness income, excluded under 26 U.S.C. § 108(a), is realized, despite the statutory requirement that all tax attributes, including suspended losses, be adjusted in the succeeding taxable year, and only after the determination of tax for the taxable year of the discharge.

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I. PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners David A. and Louise A. Gitlitz and Philip D. and Eleanor G. Winn respectfully request that this Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

II. OPINIONS BELOW

The Commissioner of the Internal Revenue issued Notices of Deficiency to Petitioners Gitlitz and Petitioners Winn. Both the Gitlitzes and the Winns timely petitioned the United States Tax Court to review the proposed deficiencies. App. 59 and App. 75. The Tax Court issued an initial opinion on June 24, 1997, reported at T.C.M. (RIA) 97,286 (App. 25). Subsequently, that opinion was withdrawn, and the Tax Court's final opinion was filed on February 19, 1998, reported at T.C.M. (RIA) 98,071. (App. 21). The Gitlitzes and Winns filed timely notices of appeal on April 27, 1998, and the Tenth Circuit affirmed the Tax Court decision in an opinion reported at *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999). (App. 1).

III. JURISDICTION

The Tax Court's jurisdiction arose under §§ 6212, 6213, 6214, and 7442 of the Internal Revenue Code (Title

26).[1] The Tenth Circuit's decision was entered on July 6, 1999, and Petitioners' timely-filed Petition for Rehearing was denied on November 3, 1999. (App. 32). This Petition is timely filed, and this Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

IV. STATUTORY PROVISIONS INVOLVED

Sections 108, 1366 and 1367 of the Internal Revenue Code of 1986 (Title 26 of the United States Code), are set forth in their entireties at App. 34, App. 52 and App. 56, respectively.

V. STATEMENT OF THE CASE

A. RELEVANT FACTS

The facts are not in dispute, and are set out in the parties' cross motions for summary judgment. Documents Nos. 6-8, 12-13 in Tax Court Docket Nos. 5359-96 (Winn) and 5358-96 (Gitlitz).[2] Petitioners David Gitlitz and Philip Winn (collectively, with their spouses, the "Taxpayers") were shareholders of P.D.W.&A., Inc.

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[1] All subsequent citations to the "Code" refer to the Internal Revenue Code of 1986, Title 26 of the United States Code. All statutory citations, unless otherwise specified, refer to that Title. Cites to Regulations or Treasury Regulations likewise refer to 26 C.F.R.

[2] The filed briefs and motions in the Tax Court are virtually identical (only the names have been changed) in *Gitlitz v. Commissioner*, Tax Court Docket No. 5389-96 and *Winn v. Commissioner*, Tax Court Docket No. 5358-96, and have identical docket numbers. For convenience, the term "Document No." refers to the records in both Tax Court cases.

("PDW&A"), a corporation that had elected to be taxed under Subchapter S of the Code. PDW&A realized cancellation of debt ("COD") income in the amount of $2,021,296 in 1991. At the time that it realized this income, PDW&A was insolvent to the extent of $2,181,748. Thus, under § 108(a)(2), PDW&A was entitled to exclude the entire amount of the cancelled indebtedness from income.

On their tax returns, the Taxpayers increased their basis in their PDW&A stock by the amount of their pro rata share of the COD income, pursuant to §§ 1366 and 1367, which generally provide that an S corporation shareholder's stock basis is increased by all items of income realized by the corporation, including non-taxable income. This increase in basis permitted the Taxpayers to deduct individually their shares of prior S corporation losses, which had been previously suspended under § 1366(d)(1) because such losses exceeded shareholder basis.

B. PROCEEDINGS IN THE U.S. TAX COURT

The Commissioner disallowed these losses, asserting that a basis increase was unavailable under the statutes. In the Tax Court, the parties filed cross motions for summary judgment. In his memorandum filed prior to oral argument on the motions, the Commissioner relied primarily upon the argument that the § 108 exclusion operates to defer or postpone the realization or recognition of COD income to a later year, such that COD income is not "tax-

exempt" within the meaning of § 1366(a)(1)(A), and therefore does not pass through to the shareholders and increase their stock basis. (Document No. 16).

However, at oral argument, the Commissioner, for the first time, relied upon Treas. Reg. § 1.61-12, and argued that, because COD income is not "realized," it is not an "item of income" within the meaning of §§ 1366 and 1367. Throughout his argument, the Commissioner took the position that the sole issue to be decided by the Tax Court was whether COD income is "realized" in the year of discharge such that it is an item of income for purposes of § 1366 that must be passed through. Counsel for the Commissioner stated "if the Court finds that excluded COD is an item of income, either tax exempt or otherwise, then we're squarely within Code section 1366, and the basis consequences would flow." (Document No. 20 at p. 31).

On June 24, 1997, the Tax Court issued its opinion in *Winn v. Commissioner*, T.C.M. (RIA) 97,286, *withdrawn and reissued as* T.C.M. (RIA) 98.071. In that opinion the Court held:

> In memoranda filed with the court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was 'deferred' and not 'tax exempt income' under § 1366(a) . . . . At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:
>
> > If the court were to hold that excluded COD (cancellation (discharge) of indebtedness) is an item of income under § 1366, then you

> would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through. . . .

We deal here solely with respondent's 'final' position.

The Tax Court went on to hold that the Commissioner's reliance upon § 1.61-12 of the regulations was misplaced, and that COD income is an item of income within the meaning of § 1366, holding for the Taxpayers.

The Commissioner filed a motion seeking reconsideration. The Commissioner argued in his motion that he had not intended to abandon at oral argument any of the arguments presented in his memoranda, and that his counsel had merely presented a "new alternative argument." (Document No. 24 at p. 2). The Commissioner also noted the existence of numerous other cases on the Tax Court docket containing the same issue. (Document No. 24 at pp. 5-6).

The Tax Court did not rule on the motion for six months. It was only after the issuance of its opinion in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), which held that the language of § 108(d)(7)(A) (requiring certain provisions of § 108 to be "applied at the corporate level" in the case of S corporations) precluded the passthrough of COD income to shareholders and eliminated any basis increase, that the Tax Court resolved the reconsideration motion. In its second opinion in *Winn v. Commissioner*, T.C.M. (RIA) 98,071, *aff'd sub nom, Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), the Tax Court granted reconsideration, withdrew its prior opinion, and issued an opinion for the Commissioner based upon the *Nelson* opinion. (App. 21).

C. PROCEEDINGS IN THE TENTH CIRCUIT

In its opinion in *Gitlitz*, the Tenth Circuit specifically rejected the Tax Court's position in *Nelson* that § 108(d)(7)(A) prevented the passthrough of COD income. 182 F.3d at 1148. However, the Tenth Circuit ruled for the Commissioner on alternate grounds, holding that COD income is eliminated at the S corporation level (before passthrough) by virtue of being "applied against" shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b).

VI. REASONS FOR GRANTING THE WRIT

The Tenth Circuit departed from the plain language of the Internal Revenue Code in order to deny a perceived windfall to Taxpayers. In reaching its conclusion, the Tenth Circuit relied primarily upon a timing statute, § 108(b)(4)(A), and interpreted that statute to require attribute reduction during, rather than after, the year of debt discharge. The Tenth Circuit's reading of § 108(b)(4)(A), and its ultimate holding that excluded COD income does not increase shareholder stock basis, is squarely contrary to the Third Circuit's opinion in *Farley v. United States*, No. 99-3209, ___ F.3d ___ (3d Cir. 2000). (App. 92)[3] Its construction of § 108(b)(4)(A) to require

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[3] The *Farley* opinion was released on January 27, 2000. As of the time that this Petition was transmitted for printing (January 30, 1999), Westlaw had not yet processed the opinion. The court's opinion in *Farley* was posted on the internet at *http://pacer.ca3.uscourts.gov/recentop/day/993209.txt* A copy of this

attribute reduction during the year of the discharge, rather than after, also conflicts with the Fifth Circuit's construction of that same statute in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 62 F.3d 398 (5th Cir. 1995), *aff'g and adopting the opinion of the Tax Court*, 103 T.C. 398 (1994).

The courts that have addressed the issue as to the effect of S corporation excluded COD income upon shareholder stock basis have reached disparate conclusions. The specialist Tax Court held for the government in *Nelson v. Commissioner*, 110 T.C. 114 (1998), on grounds that the Tenth Circuit then rejected in *Gitlitz*, 182 F.3d at 1148, and *Nelson*, 182 F.3d 1152 (10th Cir. 1999). The Third Circuit in *Farley* rejected the reasoning of both the Tax Court and the Tenth Circuit and held for the taxpayer. The Seventh Circuit recently held for the Commissioner in the case before it, but its opinion permits a shareholder basis increase for non-taxable COD income and would afford benefits to taxpayers resulting from that increase in later years. *Witzel v. Commissioner*, No. 99-2482, ___ F.3d ___, 2000 WL 30084 (7th Cir. 2000). The district court in Oregon recently held for the taxpayers for reasons similar to those set out in this Petition and in *Farley*. *Hogue v. United States*, 2000 WL 2651 (D.Ore. 2000).

Because the issue affects a significant number of insolvent corporations and their shareholders, many of whose tax cases are pending in Courts of Appeals or other courts throughout the nation, a decision by this

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posting is attached as part of the appendices at App. 92 *et seq.* In this Petition, all citations to *Farley* are to the pagination contained in that posting of the opinion.

Court is necessary to resolve the conflict that exists among the circuits and to assure uniformity of treatment, consistent with the proper application of the tax laws.[4]

A. Discharge Of Indebtedness Income Realized By An S Corporation And Excluded From Income Under 26 U.S.C. § 108 Is An Item Of Income That Increases Shareholder Basis Under 26 U.S.C. §§ 1366 And 1367.

Subchapter S of the Code (26 U.S.C. § 1361 *et seq.*) allows shareholders of qualified corporations to elect a "passthrough" system of taxation under which corporate income, losses, deductions, and credits are directly attributed to the shareholders. *Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). Income, expenses, and other tax related items of an S corporation are passed through to its individual shareholders. § 1366. If an item of income (taxable or nontaxable) is taken into account under § 1366, the shareholder's basis in the stock of the S corporation is increased by that amount. § 1367(a).

Section 61(a)(12) provides that gross income includes COD income. Section 108(a)(1)(B) provides an exclusion

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[4] Pending cases at the circuit level include *Chesapeake Outdoor Enter., Inc. v. Commissioner*, 4th Cir. No. 98-2627 (in circuit mediation program); *Guidiano v. Commissioner*, 6th Cir. No. 99-1294 (briefing complete, oral argument held December 17, 1999); *Friedman v. Commissioner*, 6th Cir. No. 99-2378 (briefing complete, oral argument held December 17, 1999); *Pugh v. Commissioner*, 11th Cir. No. 99-12646 (briefing complete, oral argument not yet scheduled). Numerous additional cases are pending in the Tax Court, in district courts, and at various administrative levels.

of such income for insolvent taxpayers up to the amount of the taxpayer's insolvency. In the case of an S corporation, subsection (a) of § 108, which determines the amount of the exclusion, is determined at the corporate level. § 108(d)(7)(A).

While COD income is excluded from gross income under § 108(a), there is a price for the exclusion in some, but not all, cases. To the extent that a bankrupt or insolvent taxpayer has what are referred to as "tax attributes" as part of his or her tax profile, section 108(b)(1) provides that "the amount [of COD income] excluded from gross income . . . shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." The attributes potentially subject to reduction under § 108(b) include net operating losses ("NOLs"), capital loss carryforwards, and basis in property. *See* § 108(b)(2)(A)-(G). In the case of S corporations, which do not have NOLs, there is a special rule which requires that individual shareholder losses, suspended because of insufficient shareholder basis under § 1366(d)(1), are to be treated as NOLs for attribute reduction purposes. § 108(d)(7)(B).

Whether excluded COD income realized by the corporation constitutes an "item of income," subject to being passed through for purposes of determining stock basis under §§ 1366 and 1367, is easily resolved by an examination of the statutes. All three Circuit Courts of Appeals and the Oregon district court have concluded that excluded COD income of an S corporation is an "item of income" within the meaning of § 1366. *Farley*, Op. at 13-14, App. at 109-110; *Gitlitz*, 182 F.3d at 1148; *Witzel*, 2000 WL 30084 at *2-*3; and *Hogue*, 2000 WL 2651 at *2. The *Gitlitz* court explained:

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

182 F.3d at 1148.

The benefit claimed by the Taxpayers in this case, i.e., an increase to shareholder basis that permits the utilization of formerly suspended losses, was thus within the language of the statutes.

B. The Initial Position Of The Commissioner And That Of The Tax Court Have Been Rejected By All Of The Circuit Courts Of Appeals To Have Considered This Issue.

Notwithstanding the clear language of the statutes, the Internal Revenue Service challenged the basis increase on the grounds that excluded COD income did not pass through to shareholders. The Commissioner's position was first articulated in a 1994 technical advice memorandum. TAM 9423003. Virtually all of the commentators concluded that the Commissioner's position was without merit and represented an ill-considered

attempt to legislate tax law through the judicial process.[5] After pointing out the legal and logical flaws in the Commissioner's arguments, the overwhelming majority of commentators concluded that the statutory provisions at issue were clear and unambiguous, and that the IRS must seek an amendment to the Code if it wished to alter the results. Although well aware of the controversial nature of his position, the Commissioner chose neither to pursue corrective legislation, nor even to clarify his position by releasing Treasury Regulations or other published guidance.

Despite the basis rules set out in §§ 1366 and 1367 of the Code, the Tax Court in *Nelson*, agreed with the Commissioner that COD income realized by an S corporation cannot be passed through to the shareholders and used to increase the basis in their stock. The Tax Court based its decision on a provision outside Subchapter S, § 108(d)(7)(A), construing the language of that statute, which provides that subsections (a), (b), (c) and (g) of § 108 are to be "applied at the corporate level," to mean

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[5] *See, e.g.*, AICPA, "Pre-Release Comments Regarding Regulations on Discharge of Indebtedness Income under Internal Revenue Code Section 1366," Apr. 5, 1995 (Reprinted in the BNA Daily Tax Report, April 10, 1995 at G-2); Lipton, "IRS Challenges S Corporation Basis Increase for COD Income," 81 J.Tax'n 340 (Dec. 1994); Lipton, "The Story of the Tortoise and the Hare: Workouts Involving S Corporations," Taxes, April 1994, p. 163; Gore, "Troubled 'S' Corporation That Recognizes COD Income May Yield Substantial Tax Benefits," 9 Tax Mgmt. Real Est. J. 80 (Apr. 7, 1993); Collins and Schneider, "TAM 9423003: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis," 6 J. of S Corp. Tax'n. 348; Eustice, "Financially Distressed S Corporations," 53 Tax Notes 97 (1991).

that COD income was excluded "at the corporate level" and could not be passed through and taken into account at the individual level. 110 T.C. at 121-122.

In reaching this conclusion, the Tax Court overlooked fundamental rules regarding the operation of provisions of Subchapter S of the Code. While under the provisions of § 1361 *et seq.*, S corporations are generally not subject to tax (§ 1363(a)), all items of income and deduction related to activities of the corporation are attributed in the first instance to the corporation, not its shareholders, and the taxable income of an S corporation as an entity is "computed in the same manner as in the case of an individual." § 1363(b). Under this system, "deductions generally allowable to individuals [are] allowed to subchapter S corporations." S. Rep. No. 97-640, 97th Cong., 2d Sess. 15 (1982), 1982-2 C.B. 718 at 724. After corporate level determinations are made, the shareholders' pro rata share of corporate items of income and deduction realized by the corporation must be "taken into account" by the shareholders in determining their individual income tax liability and basis. §§ 1366 and 1367. When the items are passed through to the shareholders, the items are treated as having the same character as they did at the corporate level. § 1366(b).

Commentators have been equally critical of the Tax Court's holding in *Nelson*.[6] The Department of Justice, in

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[6] *See* Williford, "Shareholder is Wrestled Down with a Full Nelson – Interplay of COD and S Corporation Rules," Tax Management Memorandum (August 3, 1998); Lipton, "Tax Court Rejects S Corp. Basis Step-Up for COD Income in *Nelson*," 88 J. Tax'n 272 (May 1998); Lockhart and Duffy, "Tax Court

turn, did not defend the Tax Court's holding in this regard on appeal.

When the Tenth Circuit reviewed the Tax Court decision, it found the Tax Court's interpretation of § 108(d)(7)(A) unpersuasive, discerning "no intent by Congress to treat certain subchapter S corporation income at the corporate level, while treating other income at the shareholder level." 182 F.3d at 1148. The Tenth Circuit held that such income would pass through to shareholders unless it was absorbed in the attribute reduction required by § 108(b). 182 F.3d at 1148. The Third Circuit in *Farley*, Op. at 14, and the Seventh Circuit in *Witzel*, 2000 WL 30084 at *2-*3, similarly reasoned that excluded COD income constituted an "item of income" for purposes of the § 1366 pass through.

C. The Tenth Circuit's Holding That Discharge Of Indebtedness Income Is Offset By Attribute Reduction Is Contrary To The Plain Language Of The Statutes, Which Require That Attribute Reduction Occur Following The Year Of Discharge, And Is In Conflict With The Third Circuit's Holding In *Farley v. United States*, ___ F.3d ___ (3d Cir. 2000).

The Tenth Circuit concluded that an S corporation's COD income does not pass through to shareholders and increase their stock basis because it is eliminated at the S corporation level as a result of its being "applied against"

Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis," 25 Wm. Mitchell L. Rev. 287 (1999).

shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b). However, in order to reach this result, the Tenth Circuit had to take a position squarely at odds with the timing rules for when income is realized, the tax consequences of the realization, and rules governing the timing of attribute reduction.

The Tenth Circuit considered the matter a close question and acknowledged that, if corporate attributes were reduced after the taxable year of the discharge, "the taxpayers' theory must prevail." 182 F.3d at 1148. The Tenth Circuit examined the timing statute, § 108(b)(4)(A), and interpreted that statute to provide that attribute reduction occurs during, rather than after, the taxable year of discharge and prior to the required passthrough of all items of S corporation income. However, in its construction of § 108(b)(4)(A), the Tenth Circuit disregarded:

(1) The plain language of the statute, which requires that attribute reduction "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." § 108(b)(4)(A);

(2) Section 1017 of the Code, which expressly requires that property basis, one of the attributes subject to reduction, be reduced after the year of discharge; and

(3) The rules of §§ 108(d)(7)(B) and 1366(d)(1), which require that all items of S corporation income for the year be taken into account at the shareholder level before the amount of the "suspended loss" attribute can be determined.

1. The decision of the Tenth Circuit conflicts with the plain language of 26 U.S.C. § 108(b)(4)(A) and the Third Circuit's opinion in *Farley v. United States*, ___ F.3d ___ (3d Cir. 2000).

Section 108(b)(4)(A) provides that the tax attribute reduction required by § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." This means that any tax attributes that may factor into the determination of tax for the taxable year of the discharge may be used for that purpose. It is only those attributes, if any, left over after the tax computation that are subject to reduction.

Congress understood that attribute reduction was to be postponed until after the full computation of the current year's tax liability. The Senate Report explained that § 108(b) provides that both the current year's loss and any NOL carryover to that year are potentially subject to reduction by excluded COD income, but added that "[t]hese reductions are made after the computation of the current year's tax period." S. Rep. No. 96-1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 626 n.13.

The Third Circuit in *Farley v. United States* noted that the *Gitlitz* court had concluded that the timing rule of § 108(b)(4)(A) was dispositive of the case. The *Farley* court agreed. Op. at 12, App. at 107. However, the *Farley* court saw no statutory support for the *Gitlitz* court's conclusion that § 108(b)(4)(A) was limited in its application to the computation of certain tax applications, such as limitations on deductions, charitable contribution limits, and alternative minimum tax, and did not require

the determination of the taxpayer's ultimate tax liability before attributes were reduced. *Farley*, Op. at 12 n.4, App. 108-109.

Indeed, the *Gitlitz* court's attempted limitation of § 108(b)(4)(A) to "certain tax applications," such as charitable contribution limits, creates a rule that cannot be reconciled with the language of the statutes. Under § 170, an individual taxpayer's charitable contribution deduction is limited to a percentage of his adjusted gross income (AGI), without considering NOL carrybacks from subsequent years. § 170(b)(1)(F). AGI, however, includes NOL carryforwards from prior years. A taxpayer with an NOL carryforward of $100 and $100 of excluded COD income, who makes a charitable contribution must compute his or her AGI for purposes of determining the allowable charitable contribution amount. Under the *Gitlitz* court's interpretation of § 108(b)(4)(A), the taxpayer would first include the NOL carryforward because COD income would not be applied to "eliminate" the NOL for purposes of calculation of the charitable deduction. This low AGI would serve to limit the charitable contribution deduction for the year, but then the taxpayer would have to make a second computation to determine his ultimate tax liability for the year. In that computation, the taxpayer could not use his $100 NOL because it was a tax attribute subject to reduction. The taxpayer would therefore pay twice for the COD income exclusion: the charitable contribution deduction would be limited as if there were an NOL lowering his AGI, yet his or her ultimate tax liability would be calculated without the NOL attribute.

We submit that § 108(b)(4)(A) cannot be interpreted as requiring certain initial computations that are part and

parcel of the calculation of tax liability for the year be made by taking tax attributes into account, while the final computation is made without them. The statute provides no hint that such a result is intended, nor any principled way of differentiating those computations that include tax attributes from those that do not.

The *Farley* court held that the plain language of the statute mandated the following result:

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable

> year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, Op. at 13-14, App. at 109-110.[7]

Other courts that have considered this issue have uniformly held that attribute reduction is not made until after the tax liability for the year is computed. In *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam, adopting the opinion of the Tax Court*, 62 F.3d 136 (5th Cir. 1995), the Tax Court (and the Fifth Circuit by adoption) considered the application of the attribute reduction rules in the consolidated return setting, and held that tax attribute reduction under § 108(b)(4) does not occur "until the next taxable year." 103 T.C. at 414-415.

The Tenth Circuit's opinion is also contrary to the Tax Court's holding in *Kahle v. Commissioner*, T.C.M. (RIA) 97,091. There, in considering the case of a bankruptcy estate which had come into possession of an individual taxpayer's tax attributes under § 1398, Judge Tannenwald held that, under § 108(b)(4), the taxpayer/bankrupt estate "may use the tax attributes to determine its tax liability for the year of discharge, after which the tax attributes

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[7] The Seventh Circuit in *Witzel* held that § 108 attribute reduction eliminated the suspended losses, but failed to acknowledge the existence of the § 108(b)(4)(A) timing rule.

are reduced by the estate under section 108(b)(2) before being returned to the debtor/taxpayer."

The sole authority cited by the Tenth Circuit in support of its conclusion is a treatise, C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice § 25:6, at 25-6 (3d ed. 1997). In a discussion of § 1398 (which coordinates the transfer of tax attributes between individual taxpayers in Chapter 11 and their bankruptcy estates), the treatise states, without analysis, that § 108(b)(4) provides "that tax attribute reduction must be made for the taxable year of the discharge."[8] Not only is this statement contrary to the conclusion reached by the authors of the more highly regarded Collier on Bankruptcy Taxation, *see* 15 Collier on Bankruptcy ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed. 1999), but it is contrary as well to the conclusions of every other commentator to consider the issue.[9]

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[8] The thrust of the discussion relates to the question of which entity, the taxpayer or the bankruptcy estate, is responsible for filing the Form 982, listing which attributes retained after the computation of tax are subject to reduction. This form quite logically must be filed with respect to the year of discharge.

[9] A representative sampling of the overwhelming majority of commentators who have reached this conclusion includes Witt, "Report of the [ABA] Section 108 Real Estate and Partnership Task Force," 46 Tax Law. 209, 234 (1992); Hebenstreit, "Tying Together the Tax and Bankruptcy Codes," 54 Ohio St. L.J. 859, 889 n. 21 (1993); and Tax Management Portfolio 731: S Corporation Operations, § III.B.1.a at note 414.2 (1999).

2. The Tenth Circuit's holding places the timing rules for attribute reduction under 26 U.S.C. § 108(b)(4)(A) in conflict with the timing rules for attribute reduction under 26 U.S.C. § 1017.

Section 1017 is another part of the insolvency taxation regime, and it governs the treatment of one of the tax attributes listed in § 108(b)(2): basis in assets. Section 1017(a) specifically provides that, if the taxpayer has COD income and § 108(b)(2)(E) requires a reduction in the taxpayer's basis in property as part of the attribute reduction process, then the amount of COD income applied against basis "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." Thus, under § 1017, where the taxpayer sells an asset with a $100 basis in the year of discharge for $100 and has $100 COD income, the asset basis will not be reduced by the COD income in determining the taxpayer's gain and tax liability for the year of the discharge. However, if the taxpayer instead sold the asset in the year after the discharge, his basis would have been lower, producing gain recognition and tax liability in that year.[10]

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[10] Section 108(b)(5) allows taxpayers to elect to have reduction in asset basis under §§ 108(b)(2)(E) and 1017 occur in lieu of other attribute reduction. Under § 1017, such reduction takes place the first day of the following year. The Tenth Circuit's reasoning, which generally would require attribute reduction in the year of discharge, offsetting the basis increase for COD income, would allow taxpayers with both basis in assets and suspended losses to elect, under § 108(b)(5), to have

Section 1017 was amended as part of the Bankruptcy Tax Act of 1980 (94 Stat. 3389), as was § 108. Prior to amendment in 1980, § 108 provided a much more limited exclusion for COD income, specifically conditioned upon the taxpayer's affirmative election to reduce his basis in accordance with § 1017. § 108 (1979), amended by 94 Stat. 3389 (1980). The pre-1980 version of § 1017 provided that where COD income was excluded under § 108, the taxpayer's basis in property owned at the beginning of or at any time during the taxable year of the discharge would be reduced "as of the first day of the taxable year in which the discharge occurred." § 1017 (1979), amended by 94 Stat. 3389 (1980). New §§ 108 and 1017 provide additional relief to insolvent and bankrupt taxpayers. That is, § 108(b)(4)(A) permits insolvent taxpayers who have COD income to determine their tax liability for the year of the discharge before making any attribute reduction. The timing rules of § 1017 were likewise amended so as to be consistent with new § 108(b)(4)(A), and to provide that, in the case of basis in assets, just as with all other attributes listed under § 108(b)(2), attribute reduction occurs after the year of discharge, i.e., at the beginning of the next succeeding taxable year.

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some or all of the attribute reduction (basis reduction) happen in a different year from the §§ 1366 and 1367 passthrough. This would mean that, where taxpayers made the § 108(b)(5) election, excluded COD income would be added to stock basis in the year of the discharge and would not be "absorbed" in the attribute reduction process, because attribute reduction with respect to basis in property would not occur until the following year. Such electing taxpayers would be allowed a basis increase and be permitted to make use of suspended losses during the year of the discharge, unlike their non-electing counterparts.

Rather than achieving a better interpretation of the Code, the Tenth Circuit's opinion artificially and inappropriately frustrates Congress's intention and bifurcates attribute reduction into two separate years: the year of the discharge for some attributes and the following year for basis in property. This is a perverse and indefensible result.

3. The Tenth Circuit disregarded the express language of 26 U.S.C. §§ 108(d)(7)(B) and 1366(d)(1) when it concluded that suspended losses become corporate net operating losses subject to attribute reduction before being passed through and taken into account by shareholders in the determination of their tax liability.

In explaining how it understood COD income to be "absorbed" in the attribute reduction process, the Tenth Circuit misinterpreted the relevant statutes. The Tenth Circuit stated that the corporation "first must compute its discharge of indebtedness income and set this figure aside temporarily." 182 F.3d at 1151. Then, the Tenth Circuit held that § 108(d)(7)(B) requires that shareholder suspended losses "be added to the corporation's annual net operating losses in applying the net operating loss attribute reduction." 182 F.3d at 1148. The Tenth Circuit concluded that this means that before the Taxpayers compute their stock basis, (1) the corporation must compute its NOL attribute, which equals the suspended losses of the Taxpayers from prior years, plus their current (1991) loss and (2) the corporation must then apply the COD income against the suspended losses, eliminating the

COD income for passthrough purposes. 182 F.3d at 1151.[11]

The Tenth Circuit did not recognize that the computations required by step (1) presuppose passthrough of COD income before step (2). Section 108(d)(7)(B) treats "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1)," as an attribute subject to reduction under § 108(b). Thus, the taxpayer must first make a determination as to how much loss or deduction is "allowed" and how much "disallowed" for the taxable year, pursuant to § 1366(d)(1). Section 1366(d)(1) provides that the disallowed amount is determined with reference to the shareholders' adjusted basis in their stock "determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year."

Therefore, Taxpayers must first determine their stock basis under § 1367(a), taking into account all items of income for the year, including COD income, as well as all items of loss or deduction (which include previously suspended losses from prior years under § 1366(d)(2)) in order to determine the net suspended loss for the year under § 1366(d)(1). Analytically, this calculation of basis under § 1367 must be made prior to the time such suspended loss for the year comes into existence pursuant to

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[11] The Seventh Circuit in *Witzel* disagreed with the Tenth Circuit's opinion in *Gitlitz* in this regard, reasoning that statutory attribute reduction did not prevent the §§ 1366 and 1367 passthrough of income and basis increase. 2000 WL 30084, at *2-*3. Basis would then be available to absorb future year losses, or to be taken into account at disposition.

§ 1366(d)(1) and becomes an "attribute" subject to reduction pursuant to § 108(d)(7)(B). Only that amount of loss, if any, which exceeds the shareholder's share of all corporate income for the year, including excluded COD income, is actually "disallowed for the taxable year of the discharge" under § 1366(d)(1) and subject to attribute reduction. Thus, it is a violation of the statutory schema to "temporarily set aside" the COD income and calculate suspended losses for the year; the COD income must be taken into account in computing the disallowed losses at the shareholder level under §§ 108(d)(7)(B) and § 1366(d)(1).

D. The Tenth Circuit's Opinion Conflicts With The Standards Of Statutory Interpretation Established By This Court.

The real reason that the Tenth Circuit and the Tax Court held for the IRS in *Gitlitz* was not that the statutory language compelled the position advanced by the Commissioner, but rather because the courts perceived the Taxpayers' position would result in a "windfall." This perception is unfounded.[12] The Taxpayers merely seek equal treatment with other insolvent taxpayers. In its opposition to Petitioners' Petition for Rehearing in the

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[12] The *Farley* court noted the government had presented scant evidence that following the statutory language would provide the taxpayers with benefits not intended. Op. at 14-15, App. at 110-112. Moreover, the *Farley* court reasoned that in cases where an S corporation had basis in property in excess of encumbrances on that property equal to or greater than the amount of the discharge, there would not be even the possibility of an unwarranted benefit. Op. at 17, App. at 114.

Tenth Circuit, the Commissioner publicly disavowed any intention of applying the timing rule adopted by the *Gitlitz* court to any attribute other than suspended losses. Response to Appellants' Petition for Rehearing, pp. 5-7. The Commissioner apparently agrees that other insolvent taxpayers receive the full benefit of the exclusion of income, as well as the full use of any tax attributes to reduce tax liability during the year of the discharge. Suspended losses are governed by the same timing rules applicable to all other tax attributes, and should be available to reduce tax liability, but only in the year of the discharge. The language of § 108(b)(4)(A) applies equally to all attributes; there is no way to parse the language of § 108(b)(4)(A) to provide for the reduction of certain disfavored attributes in the year of the discharge, but other more favored attributes in the subsequent year.

The opinion in *Gitlitz* in effect treats excluded COD income just as if it were fully taxable income and not subject to an exclusion under § 108. If the COD income had been taxable income, Taxpayers would have increased their basis by the amount of the COD income. The suspended losses would then have been freed up, offsetting the taxable income and reducing the Taxpayer's basis under § 1367(a)(2)(B). This is exactly the same position as the *Gitlitz* opinion places Taxpayers, who were supposed to receive the benefit of an exclusion from tax. To avoid a perceived "windfall," the Tenth Circuit has unfairly denied any benefit flowing from the § 108(a) exclusion; it might as well have been taxable income.

This is a case where the cure is worse than the disease. The federal courts do not have the authority to revise and distort the Code in order to reach what the

Commissioner portrays as better tax policy. *See Abdalla v. Commissioner*, 647 F.2d 487, 503 (5th Cir. 1981); *International Trading Company v. Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973). In *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 841 (5th Cir. 1992), the court clearly articulated this Court's longstanding requirement that courts construe the Code as written:

> Indeed, the Supreme Court stated in *Hanover* [*Hanover Bank v. Commissioner*, 369 U.S. 672 (1962)] that 'we are not at liberty, not withstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of a statute.' 369 U.S. at 387, 82 S.Ct. at 1089. Similarly, the Court has explained that 'where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.' *Lewyt Corp. v. Commissioner of Internal Revenue*, 349 U.S. 237, 240, 75 S.Ct. 736, 739, 99 L.Ed. 1029 (1955). Therefore, although we should try to avoid double tax benefits, courts must leave them standing if the code positively requires this outcome.

Nothing in the language of the statutes relating to the passthrough of income and the calculation of basis or the statute relating to the exclusion of COD income even remotely suggests that taxpayers cannot increase their stock basis by COD income and deduct losses prior to engaging in attribute reduction.

Perhaps the best evidence of the absence of statutory support for the Commissioner's position is the history of

this litigation. Initially, in the Tax Court, the Commissioner argued that COD income is not "tax exempt," then later that COD income is not "realized." The Tax Court rejected the "no realization" position, but reversed itself, relying upon the "applied at the corporate level" language of § 108(d)(7)(A) to hold that losses are never passed through to shareholders. In litigation before the Tenth Circuit, the Commissioner abandoned that argument altogether and, without citing any authority, urged that the pass through doesn't take place because COD income is "temporarily set aside" and then eliminated in the attribute reduction process. Appellee Brief at 28. The Tenth Circuit adopted a variant of the government's position, believing that it had found the statutory anchor missing from the government's position in § 108(b)(4)(A).

The interpretation of the Code, however, should not be a moving target, requiring taxpayers to overcome an endless stream of successive arguments based upon what the Commissioner or the courts believe should be the law. It should be based upon the language of the statutes as written.

VIII. CONCLUSION

This Court should grant a writ of certiorari to resolve the conflict between the decisions in *Gitlitz* and *Witzel* and those in *Farley*, *CSI*, and *Hogue*.

RESPECTFULLY SUBMITTED this 1st day of February, 2000.

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PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

DAVID A. GITLITZ; LOUISE A. GITLITZ, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee. and PHILIP D. WINN; ELEANOR G. WINN, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 98-9009 No. 98-9010

APPEALS FROM UNITED STATES TAX COURT
(T.C. Nos. 5358-96 & 5359-96)

(Filed July 6, 1999)

Darrell D. Hallett (John M. Colvin with him on the brief), Chicoine & Hallett, P.S., Seattle, Washington, for the appellants.

Edward T. Perelmuter (Loretta C. Argrett, Assistant Attorney General, and Teresa E. McLaughlin with him on the brief), of the Tax Division, Department of Justice, Washington, D.C., for the appellee.

Before **TACHA, MAGILL,*** and **BRISCOE,** Circuit Judges.

BRISCOE, Circuit Judge.

The Commissioner of Internal Revenue assessed tax deficiencies against David and Louise Gitlitz and Philip and Eleanor Winn after determining the taxpayers improperly utilized excluded discharge of indebtedness income to adjust their subchapter S corporate bases. The United States Tax Court upheld the Commissioner's deficiency determinations and taxpayers now appeal. We exercise jurisdiction pursuant to 26 U.S.C. § 7482(a)(1) and affirm.

I.

David Gitlitz and Philip Winn each owned a fifty-percent interest in PDW & A, Inc., a Colorado corporation that elected to be taxed under subchapter S of the Internal

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* Honorable Frank J. Magill, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

Revenue Code. PDW & A was a partner in Parker Properties Joint Venture, a real estate partnership. In 1991, Parker Properties realized $4,154,891 in discharge of indebtedness income; PDW & A's pro rata share was $2,021,296. At that time, PDW & A was insolvent to the extent of $2,181,748 and thus was excluded from tax liability for the discharged debt income. *See* 26 U.S.C. §§ 108(a)(1)(B), 108(d)(6).[1]

Entering the 1991 tax year, both Gitlitz and Winn had suspended (i.e., unused) losses because each lacked sufficient basis in PDW & A to deduct losses in prior years. *See* 26 U.S.C. § 1366(d)(1)(A) (the "aggregate amount of losses and deductions taken into account by a shareholder under [§ 1366(a)] for any taxable year shall not exceed . . . the adjusted basis of the shareholder's stock in the S corporation"); 26 U.S.C. § 1366(d)(2) ("Any loss or deduction which is disallowed for any taxable year by reason of [§ 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder."). In 1991, Gitlitz and Winn each had additional losses from their association with PDW & A (i.e., pro rata shares of PDW & A's 1991 operating losses) which, when combined with their suspended losses, totaled $1,010,648.[2] Absent an increase in basis, Gitlitz

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[1] With partnerships such as Parker Properties, the insolvency-based discharge of indebtedness income exclusion is assessed at the *partner* level. *See* 26 U.S.C. § 108(d)(6).

[2] Gitlitz had $538,423 in 1991 pro rata losses and $472,225 in suspended losses from previous tax years. Although the record does not reflect how Winn's losses were broken down, it appears he used a calculation similar to that used by Gitlitz.

and Winn would have had to treat these losses as suspended losses under § 1366(d)(1) because their bases in the corporation would have remained insufficient to permit contemporaneous recognition.

On their respective joint income tax returns for the relevant tax years, Gitlitz and Winn claimed increases in the bases of their PDW & A stock in the amount of their pro rata shares of the excluded discharge of indebtedness income.[3] Gitlitz and Winn maintained the excluded discharged debt was an "item of income (including tax exempt income)," as that term is used in § 1366(a)(1)(A), thereby facilitating their basis increases pursuant to 26 U.S.C. § 1367(a)(1)(A). With the basis adjustments, the validity of which is at issue here, Gitlitz and Winn were able to claim the full amount of their pro rata share of PDW & A's ordinary losses.

The Commissioner determined the taxpayers could not use PDW & A's excluded discharge of indebtedness income to increase their bases in the corporation stock and denied the taxpayers' ordinary loss deductions. The taxpayers contested the deficiency determinations. The Tax Court initially issued a consolidated opinion in favor of the taxpayers, but later granted the Commissioner's motion for reconsideration. The court relied on its "reviewed decision" in *Nelson v. Commissioner*, 110 T.C. 114 (1998), and upheld the Commissioner's deficiency

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[3] Gitlitz reflected the adjusted basis on his 1991 return and Winn reflected the adjustment on his 1992 return. Winn did not employ a basis adjustment to facilitate an ordinary loss deduction on his 1991 joint tax return because he believed passive activity loss limitations prevented him from doing so.

determinations, determining discharge of indebtedness income, which is excluded from gross income under § 108(a), does not pass through to shareholders of subchapter S corporations. Thus, the court concluded a subchapter S corporation's shareholder may not use the corporation's untaxed discharge of indebtedness income to increase the shareholder's adjusted basis of corporate stock.

II.

Decisions of the United States Tax Court are reviewed "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury." 26 U.S.C. § 7482(a)(1). We review factual findings for clear error and legal conclusions de novo. *Schelble v. Commissioner,* 130 F.3d 1388, 1391 (10th Cir. 1997). Because the only issue here is whether the law applied to the undisputed facts satisfies the relevant statutory standard, we review the Tax Court's decision de novo as we are equally competent to draw conclusions from undisputed facts. *Id.* (citing *Anderson v. Commissioner,* 62 F.3d 1266, 1270 (10th Cir. 1995)).

III.

Before reaching the merits of taxpayers' arguments, we address their contention that the Commissioner waived in the Tax Court many of the arguments now asserted on appeal. The Commissioner made clear in its motion for reconsideration that, notwithstanding certain ambiguous comments of counsel during the summary

judgment hearing, it did not intend to waive any arguments previously asserted in its summary judgment motion. The Tax court apparently accepted the Commissioner's clarification in the order granting reconsideration. Such a decision is committed to the lower court's sound discretion, *see Elsken v. Network Multi-Family Sec. Corp.*, 49 F.3d 1470, 1476 (10th Cir. 1995), and we discern no abuse here. Further, "it is well-settled that a court is not bound by stipulations of the parties as to questions of law." *Koch v. United States*, 47 F.3d 1015, 1018 (10th Cir. 1995) (citations and internal alterations omitted). "[O]ur analysis, which may rest on any grounds for which there is a record sufficient to permit conclusions of law, even grounds not relied on by the district court, is not constrained by the government's ill-considered concession." *United States v. Furman*, 112 F.3d 435, 438 n.2 (10th Cir. 1997) (citations omitted).

Subchapter S Corporations

Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379, permits certain corporations to elect to be taxed in a similar, but not identical, fashion as partnerships. *See* 3 Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 95.6.1 (2d ed. 1991) (highlighting major distinctions). A subchapter S corporation generally does not pay taxes as an entity. 26 U.S.C. § 1363(a). Instead, the corporation's profits and losses pass through directly to its shareholders on a pro rata basis and are then reported on the shareholders' individual tax returns. 26 U.S.C. § 1366(a). This conduit approach allows shareholders to avoid double taxation on corporate earnings. Tax integrity, meanwhile, is preserved by

requiring shareholders to treat all income and deductions as if "realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." 26 U.S.C. § 1366(b). In other words, "the items attain no greater dignity from being passed through the corporation." Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 6.06[2][c] (6th ed.1998).

To further prevent double taxation of subchapter S corporate income upon distribution to shareholders, § 1367(a) normally requires shareholders to adjust their corporate bases by the items identified in § 1366(a). In particular, basis must be increased by, *inter alia*, the items of income delineated in § 1366(a)(1)(A). Basis must be decreased by, *inter alia*, the items of loss and deduction set forth in § 1366(a)(1)(A), as well as corporate distributions previously excluded from shareholders' income pursuant to 26 U.S.C. § 1368(b). Section 1368(b) provides that distributions of a subchapter § corporation having no earnings and profits (as is the case with PDW & A) are treated as follows:

> (1) *Amount applied against basis.* – The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.
>
> (2) *Amount in excess of basis.* – If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

Two examples help explain how this statutory scheme operates. Assume the sole shareholder of a subchapter S corporation has a basis of $100 in the corporation's stock. The corporation realizes $200 in taxable income. At the end of the tax year, the shareholder pays tax on the $200 of income under the "pass through" principles described above. The corporation distributes the $200 to the shareholder the following year. In the absence of an upward basis adjustment, the shareholder would be liable for additional tax upon the distribution pursuant to § 1368(b)(2) because the amount of the distribution ($200) exceeds his preexisting basis in the stock. Sections 1366 and 1367 prevent this double taxation by mandating a $200 basis increase when the corporation first realizes the income and a $200 basis decrease upon the corporation's distribution of the income.

A second example illustrates how the character of tax-exempt income is preserved under the subchapter S framework. Assume the same subchapter S corporation realizes $200 in tax-exempt income. Although a "pass through" technically occurs, the shareholder pays no tax on the income because, under § 1366(b), the income after "pass through" has the same character as if it was realized by the corporation. The corporation distributes the income to its shareholder the next year. Without the requisite basis adjustment, the shareholder would be forced to pay tax on the distribution under § 1368(b)(2) because the amount of the distribution exceeds his preexisting basis in the stock. Once again, §§ 1366 and 1367 prevent such a result by dictating a $200 basis increase when the corporation first realizes the income and a $200 basis decrease upon the corporation's distribution of the

income. As a result, the shareholder pays no taxes on the income.

Discharge of Indebtedness Income and Insolvency Exception

Section 61(a)(12) of the Internal Revenue Code, 26 U.S.C. § 61(a)(12), ordinarily requires a taxpayer who has incurred a financial obligation, which is later discharged in whole or in part, to recognize as taxable income the extent of the reduction in the obligation. Section 108(a)(1) provides an exception to this rule if, *inter alia*, the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent. Exclusion of discharge of indebtedness from gross income, however, does not come without a price. Specifically, a taxpayer omitting such discharged debt from his income must make correlative reductions in various "tax attributes" that could otherwise yield future tax benefits. *See* 26 U.S.C. § 108(b). After the requisite tax attribute reductions have been made, any "remaining debt discharge amount is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 96-1035, at 2 (1980), *reprinted* in 1980 U.S.C.C.A.N. 7017, 7018. This statutory scheme has "the effect of relieving the taxpayer of immediate recognition of debt discharge income, but at the cost of a forfeiture of an equal amount of potential tax benefit." 1 Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed.1999).[4]

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[4] If a taxpayer's attributes are insufficient to absorb all of his cancellation of indebtedness income, § 108 effectively provides a permanent exemption from taxation on that income.

In this case of first impression, taxpayers maintain PDW & A's canceled debt is an "item of income (including tax exempt income)" under § 1366(a)(1)(A). As the taxpayers see it, PDW & A's debt discharge, because it is an item of income under § 1366(a)(1)(A), passes through to them immediately by way of § 1366 and allows them to increase their basis in the corporation pursuant to § 1367(a)(1)(A). If we embrace taxpayers' position, subchapter S corporate shareholders would receive a windfall. Not only would shareholders avoid taxation on the corporation's discharged debt, they would also receive an upward basis adjustment, thereby permitting them to report a larger capital loss from the sale of their stock. In addition, shareholders would be able to use the corporation's net operating losses to reduce their own non-corporate related gross income without having to decrease the net operating losses by the amount of the corporation's discharged debt. Taxpayers acknowledge the windfall, but insist the statutory language dictates such a result.

The Supreme Court has held the Internal Revenue Code "should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction absent a clear declaration of intent by Congress." *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (citations omitted). We believe this principle is equally applicable to windfalls. Accordingly, only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here. Although taxpayers make some compelling arguments, we do not believe Congress intended to confer such a windfall upon individuals in their position.

Exclusion of Discharge of Indebtedness Income at Corporate Level

With subchapter S corporations, § 108's discharge of indebtedness income exclusions *and* tax attribute reduction principles must be applied at the *corporate* level. 26 U.S.C. § 108(d)(7)(A). The Commissioner argues, and the Tax Court held, this rule serves as an exception to the normal pass-through practice in which items of income percolate directly to a corporation's shareholders. Taxpayers claim, however, that the only purpose of § 108(d)(7)(A) is to create uniformity in the tax treatment of subchapter S corporations by applying the insolvency test at the corporate rather than shareholder level. If the corporation is solvent, the debt discharge is taxable; if the corporation is insolvent, the canceled debt is excluded from gross income up to the amount of the corporation's insolvency. Under either scenario, the taxpayers insist, the pass-through principles of subchapter S are fully applicable and shareholders must adjust their bases in the corporation. Although taxpayers' argument is not without merit, we reject it in favor of a position closer, although not identical, to that of the Commissioner.

We note preliminarily that the parties have devoted significant discussion to the legislative history of the Subchapter S Revision Act of 1982, Pub.L. No. 97-354, 96 Stat. 1669, which adopted 26 U.S.C. §§ 1366-1368, and the Tax Reform Act of 1984, Pub.L. No. 98-369, 98 Stat. 494, which amended 26 U.S.C. § 1366. We find this legislative history largely unhelpful. The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the

corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that *all* items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures *precede* the pass-through, the corporation's excluded discharge of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. Potential windfalls are thus avoided. If, on the other hand, attribute reduction takes place *after* the pass-through, the taxpayers' theory must prevail. For the reasons described below, we conclude attribute reduction must precede the pass-through.

Shareholder Suspended Losses as Corporate Net Operating Losses

Section 108(d)(7)(B) provides that, in administering the tax attribute reduction scheme, shareholder losses suspended pursuant to § 1366(d)(1) must be treated as net operating losses for purposes of § 108(b)(2)(A), thereby precluding subchapter S corporation shareholders with carryover losses from enjoying the tax benefits of ordinary losses while simultaneously avoiding taxation on discharge of indebtedness income. As we interpret this statute, these suspended losses are added to the corporation's annual net operating losses in applying the net operating loss tax attribute reduction.

Taxpayers maintain subchapter S corporations, by their very nature, have no net operating losses, and suggest the net operating loss tax attribute is confined to shareholder suspended losses. We have found no case law squarely addressing this issue. It is true that, because a subchapter S corporation's losses are normally deductible only by its shareholders and only to the extent of their bases in the corporation, *see* § 1366(d)(1), the corporation itself is not permitted to take a net operating loss deduction. However, nothing in the Internal Revenue Code mandates that corporate net operating losses pass through *immediately* to shareholders. If pass through was immediate, shareholders could secure a windfall by (1) avoiding tax on corporate discharge of indebtedness income under § 108(a), and (2) employing the corporation's passed-through net operating losses to reduce their own non-corporate related gross income without having first decreased the net operating losses by the amount of the corporation's discharged debt. The inequity would be magnified further if the shareholder's pre-pass-through basis was insufficient to recognize the net operating losses, and recognition was only possible as a result of the discharged debt increasing the shareholder's basis. Moreover, regardless of the pre-pass-through basis, the increase in basis resulting from an immediate pass-through of nontaxable discharge of indebtedness income would permit shareholders to secure a higher capital loss upon the ultimate disposition of the corporation.

To embrace the taxpayers' position is to effectively eliminate the "price" Congress imposed upon entities whose discharged debt income is excluded under § 108. We conclude when § 108(a)'s discharge of indebtedness

income exclusion is triggered, a shareholder's pro rata share of the corporation's net operating losses passes through to him only to the extent such losses are not absorbed by the shareholder's pro rata share of the excluded canceled debt.[5]

26 U.S.C. § 108(b)(4)(A)

The most difficult aspect of this case is determining the role § 108(b)(4)(A) plays in the tax calculation. This section states the attribute reductions outlined in § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." Taxpayers suggest an insolvent subchapter S corporation's discharge of indebtedness may be used in the current tax year to increase shareholder basis because the requisite tax attribute reduction does not occur until the following year. In essence, they claim the corporation's excluded discharge of indebtedness income passes through to them immediately upon recognition by the corporation.

Unfortunately, there is no case law and commentators are divided on the proper operational mechanics of

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[5] Although not applicable to this case, the Internal Revenue Service recently proposed regulations providing that excluded discharge of indebtedness income may never be treated as tax-exempt income under § 1366(a)(1)(A), and is thus not susceptible to a pass-through, because the excluded income is generally only deferred, and not permanently exempted. *See* 63 Fed.Reg. 44181, 44182-44183 (1998) (discussing rationale for proposed Treas. Reg. § 1.1366-1(a)(2)(viii)). We do not address the validity of this proposed regulation.

§ 108(b)(4)(A). *Compare* C. Richard McQueen and Jack F. Williams, *Tax Aspects of Bankruptcy Law and Practice* § 25:6, at 25-6 (3d ed.1997) (tax attribute reductions made in year of discharge) *with* 15 *Collier on Bankruptcy* ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed.1999) (tax attribute reductions made in year following discharge). The only point upon which all agree is that § 108(b)(4)(A) is not an example of legislative clarity. Although a close question, we ultimately conclude the taxpayers' theory is not compelling. According to § 108(d)(7)(A), tax attributes reductions must be applied at the corporate level with subchapter S corporations. Taxpayers' proposal would not give effect to the attribute reduction scheme. Taxpayers' approach, in fact, would thwart the purpose of the net operating loss tax attribute:

> By reason of the debt discharge, losses sustained by the taxpayer have been borne by the taxpayer's creditors. Normally, this would be reflected by requiring that the taxpayer recognize gross income in the year of the discharge to offset its earlier deductions of the shifted losses. However, because the losses have not yet yielded tax benefit, this rule simply shaves down the loss deductions to eliminate the portions not ultimately borne by the taxpayer.

1 Bittker and Lokken, *supra* ¶ 7.6.3, at 7-59.

As we see it, § 108(b)(4)(A) is simply designed to compute certain tax applications (e.g., establishing income ceilings for § 108(b)(2) deductions/credits, assessing charitable contribution deduction limitations, evaluating application of possible alternative minimum tax, etc.) before reducing tax attributes. We do not read the

statute as mandating that attribute reductions be made *in the tax year following the year of the discharge.* We concede that, if § 108(b)(4)(A) is read narrowly and in isolation, it is plausible to conclude Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge. But we must read the Internal Revenue Code as a whole. *UNUM Corp. v. United States,* 130 F.3d 501, 507 (1st Cir. 1997). "[T]he expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history [may] often defeat the object intended to be accomplished." *Id.* (quoting *Helvering v. New York Trust Co.,* 292 U.S. 455, 464 (1934)). Taxpayers' interpretation of § 108(b)(4)(A) would negate the effect of the tax attribution scheme and would give taxpayers an unwarranted windfall.[6]

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[6] The following examples underscore how our interpretation of the interplay between §§ 108 and 1366-1368 operates in practice. In each example, X is the sole shareholder of an insolvent subchapter S corporation.

Example 1: In 1991, the corporation realizes $500 of discharge of indebtedness income and has $100 of net operating losses. The corporation has no other tax attributes and X has no suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily (i.e., it does not pass through immediately to X). The corporation then calculates its net operating losses for the year. Finally, the corporation applies the excluded discharged debt to reduce its tax attributes in accordance with §§ 108(b)(2) and 108(d)(7)(B). After reducing the $500 in discharged debt by the $100 in net operating losses, $400 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required reduction of tax attributes, this $400 is ignored and has no tax

In 1991, PDW & A realized $2,021,296 in cancellation of indebtedness income. PDW & A was insolvent to the

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consequences. Thus, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor can he adjust his corporate basis.

Example 2: Same facts as example 1, but now the corporation realizes $100 of discharge of indebtedness income and $500 of net operating losses. In calculating its 1991 tax return under the method described above, after reducing the $100 in discharged debt, dollar for dollar, by the net operating losses, $400 of net operating losses remains. The $400 of net operating losses flows through to X and, assuming he has a sufficient basis in the corporation, may be used by him to offset his own gross income.

Example 3: In 1991, the corporation realizes $500 of discharge of indebtedness income and has $100 of net operating losses. The corporation has no other tax attributes. X has $200 in suspended losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation then calculates its net operating loss tax attribute ($100 + $200 = $300). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the $500 in discharged debt by the $300 net operating loss tax attribute, $200 of canceled debt remains. Because any remaining debt discharge amount is disregarded following the required tax attribute reductions, this $200 is ignored and has no tax consequences. As a result, there are no items of income to pass through to X. X cannot utilize any net operating losses incurred by the corporation to offset his own gross income nor may he adjust his corporate basis. X has also permanently lost the use of $200 in suspended losses.

Example 4: Same facts as example 3, but now the corporation realizes $100 of discharge of indebtedness income and has $500 of net operating losses. In calculating its 1991 tax return, the corporation first computes its discharged debt income and sets this figure aside temporarily. The corporation

full extent of this figure and thus was excluded from paying taxes on the canceled debt. Shareholders Gitlitz and Winn each had a $1,010,648 pro rata share of discharged debt. Additionally, Gitlitz and Winn each had a combination of pro rata 1991 net operating losses and suspended losses from prior years which totaled $1,010,648. See footnote 2. In calculating its 1991 taxes, PDW & A first must compute its discharge of indebtedness income and set this figure aside temporarily. The corporation then must calculate its net operating loss tax attribute ($1,010,648 for Gitlitz + $1,010,648 for Winn = $2,021,296). Finally, the corporation must apply the excluded discharged debt to reduce its tax attributes. In this case, the net operating loss tax attribute fully absorbs the corporation's excluded discharge of indebtedness income. Thus, there are no items of income to pass through to Gitlitz and Winn. The shareholders cannot utilize any net operating losses incurred by PDW & A to offset their own gross income or to adjust their corporate basis. Further, the suspended losses of Gitlitz and Winn effectively disappear and have no future tax consequences.

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then calculates its net operating loss tax attribute ($500 + $200 = $700). Finally, the corporation applies the excluded discharged debt to reduce its tax attributes. After reducing the $100 in discharged debt, dollar for dollar, by the net operating losses, $400 of 1991 net operating losses remains in addition to X's $200 of suspended losses. The $600 combined amount flows through to X and, depending on his basis, may be used by him (in whole or in part) to offset his own gross income.

Holding Confined to Excluded Discharge of Indebtedness Income

We emphasize this case focuses only on excluded discharge of indebtedness income vis-a-vis insolvent subchapter S corporations. The special exception for treating such excluded income at the corporate level in § 108(d)(7)(A) and the tax attribute reduction scheme in § 108(b) have no application to other forms of tax-exempt income.[7] The distinction is particularly logical when one considers that subchapter S corporation shareholders generally are not entitled to include the corporation's indebtedness to third parties in calculating their basis. *Uri v. Commissioner,* 949 F.2d 371, 373 (10th Cir. 1991). The theory behind this rule is that the shareholders themselves have made no economic outlay. *See Goatcher v. United States,* 944 F.2d 747, 751 (10th Cir. 1991) (citing *Estate of Leavitt v. Commissioner,* 875 F.2d 420, 422 (4th Cir. 1989)). The types of tax-exempt income the taxpayers reference (i.e., non-taxable life insurance proceeds and municipal bond income) are acquired through initial economic outlays.

CSI Hydrostatic Testers

Taxpayers suggest the holding in *CSI Hydrostatic Testers, Inc. v. Commissioner,* 103 T.C. 398 (1994), *aff'd,* 62 F.3d 136 (5th Cir. 1995) (per curiam) is inconsistent with the holding here. *CSI* is unrelated to the present case. The

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[7] We assume here that excluded discharge of indebtedness income is tax-exempt income. As noted earlier, Internal Revenue has proposed regulations that would foreclose such a classification.

issue in *CSI* was whether discharge of indebtedness income, which was excluded from the taxable income of a subsidiary *subchapter C* corporation pursuant to § 108(a), had to be included in the subsidiary's earnings and profits. The case turned on interpretations of 26 U.S.C. § 312(*l*) and 26 C.F.R. § 1.1502-19 (1987). Subchapter S corporations were not at issue. Nor was the potential windfall question before us even considered. In sum, taxpayers' reliance on *CSI* is inapposite. Taxpayers' remaining arguments have been rendered moot by the preceding discussion.

The decision of the Tax Court is AFFIRMED. Taxpayers' motion to supplement the record with a letter which was not a part of the record before the Tax Court is DENIED.

T.C. Memo. 1998-71

UNITED STATES TAX COURT

PHILIP D. AND ELEANOR G. WINN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent*

DAVID A. AND LOUISE A. GITLITZ, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5358-96, 5359-96.
Filed February 19, 1998

Darrell D. Hallett, Larry N. Johnson, Robert J. Chicoine, and *John M. Colvin,* for petitioners.

Keith G. Medleau, for respondent.

MEMORANDUM OPINION

COHEN, Chief Judge: In *Winn v. Commissioner,* T.C. Memo. 1997-286, we concluded that respondent's motions for summary judgment should be denied, and petitioners' cross-motions for partial summary judgment should be granted. Thereafter, respondent filed a motion for reconsideration. Released today is the Opinion in *Nelson v. Commissioner,* 110 T.C. ___ (1998), in which the Court decides the same legal issue, to wit, whether discharge of indebtedness income to an S corporation increases a shareholder's basis in the stock of the corporation, in favor of respondent. The arguments discussed in *Nelson* were fully briefed and argued in these cases. Under these

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* This opinion replaces the prior opinion of this Court in these cases, *Winn v. Commissioner,* T.C. Memo. 1997-286, which is hereby withdrawn.

circumstances, respondent's motion for reconsideration will be granted. This Memorandum Opinion replaces T.C. Memo. 1997-286, which is hereby withdrawn.

Background

Respondent determined a deficiency of $242,555 in Philip D. and Eleanor G. Winn's (the Winns) 1992 Federal income tax and a deficiency of $251,192 in David A. and Louise A. Gitlitz's (the Gitlitzes) 1991 Federal income tax. At the time their respective petitions were filed, all petitioners resided in Colorado.

Philip D. Winn (Winn) and David A. Gitlitz (Gitlitz) were shareholders in P.D.W. & A., Inc. (PDW&A), a Colorado corporation. In 1991, PDW&A had an election in effect to be taxed as an S corporation. Effective January 1, 1992, PDW&A revoked its S corporation election.

PDW&A was a partner in Parker Properties Joint Venture (Parker). Parker realized $4,154,891 in discharge of indebtedness income in 1991. PDW&A's distributive share of Parker's discharge of indebtedness income in 1991 was $2,021,296. At the time that Parker realized the discharge of indebtedness income, PDW&A was insolvent to the extent of $2,181,748.

Winn increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Winn did not claim a loss on the Winns' 1991 Federal income tax return because Winn believed that the passive activity loss limitations prevented him from doing so. On the Winns' 1992 Federal

income tax return, Winn claimed losses from PDW&A that were carried over from 1991 totaling $1,010,648.

Gitlitz increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Gitlitz claimed losses from PDW&A totaling $1,010,648 on the Gitlitzes' 1991 Federal income tax return. Absent the basis increase, the deductibility of these losses would have been suspended under section 1366(d), I.R.C.

Respondent disallowed the losses claimed by Winn and Gitlitz on the premise Winn and Gitlitz lacked sufficient basis in their PDW&A stock.

Discussion

Under Rule 121, Tax Court Rules of Practice and Procedure, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b), Tax Court Rules of Practice and Procedure. The parties agree that whether discharge of indebtedness income increases a taxpayer's basis in his S corporation stock may be decided as a matter of law.

In *Nelson v. Commissioner*, 110 T.C. ___, filed this date, the Court agreed with respondent that a shareholder of an insolvent S corporation may not increase his or her basis to reflect discharge of indebtedness income to the S

corporation. That Opinion is controlling here. Respondent's motions for summary judgment will be granted, and petitioners' cross-motions for partial summary judgment will be denied.

Appropriate orders will be issued.

T.C. Memo. 1997-286

UNITED STATES TAX COURT

PHILIP D. AND ELEANOR G. WINN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

DAVID A. AND LOUISE A. GITLITZ, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5358-96, 5359-96.
Filed June 24, 1997

Darrell D. Hallett, Larry N. Johnson, Robert J. Chicoine, and *John M. Colvin,* for petitioners.

Keith G. Medleau, for respondent.

MEMORANDUM OPINION

COHEN, *Chief Judge*: Respondent determined a deficiency of $242,555 in Philip D. and Eleanor G. Winn's (the Winns) 1992 Federal income tax and a deficiency of $251,192 in David A. and Louise A. Gitlitz's (the Gitlitzes) 1991 Federal income tax. The issue for decision is whether Philip D. Winn (Winn) and David A. Gitlitz (Gitlitz) are entitled to claimed S corporation losses of approximately $1 million, which in turn depends upon whether Winn and Gitlitz may increase their respective adjusted bases in the S corporation stock by their pro rata allocation of discharge of indebtedness income.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

These matters are before the Court on respondent's motions for summary judgment filed January 31, 1997, and on petitioners' cross-motions for partial summary judgment filed March 25, 1997.

Background

At the time their respective petitions were filed, all petitioners resided in Colorado.

Winn and Gitlitz were shareholders in P.D.W. & A., Inc. (PDW&A), a Colorado corporation. In 1991, PDW&A had an election in effect to be taxed as a subchapter S corporation. Effective January 1, 1992, PDW&A revoked its S corporation election.

PDW&A was a partner in Parker Properties Joint Venture (Parker). Parker realized $4,154,891 in discharge of indebtedness income in 1991. PDW&A's distributive share of Parker's discharge of indebtedness income in 1991 was $2,021,296. At the time that Parker realized the discharge of indebtedness income, PDW&A was insolvent to the extent of $2,181,748.

Winn increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge of indebtedness income. Winn did not claim a loss on the Winns' 1991 Federal income tax return because Winn believed that the passive activity loss limitations prevented him from doing so. On the Winns' 1992 Federal income tax return, Winn claimed losses from PDW&A that were carried over from 1991 totaling $1,010,648.

Gitlitz increased his basis in his PDW&A stock by the amount of his pro rata share ($1,010,648) of the discharge

of indebtedness income. Gitlitz claimed losses from PDW&A totaling $1,010,648 on the Gitlitzes' 1991 Federal income tax return. Absent the basis increase, the deductibility of these losses would have been suspended under section 1366(d).

Respondent disallowed the losses claimed by Winn and Gitlitz on the premise Winn and Gitlitz lacked sufficient basis in their PDW&A stock.

Discussion

Under Rule 121, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). The parties agree that whether discharge of indebtedness income increases a taxpayer's basis in his S corporation stock may be decided as a matter of law.

Section 1367(a)(1) provides:

> (1) Increases in basis. – The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> > (A) the items of income described in subparagraph (A) of section 1366(a)(1),
> >
> > (B) any nonseparately computed income determined under subparagraph (B) of section 1366 (a) (1), and

> (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 1366(a)(1) provides:

> (1) In general. – In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's –
>
> > (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
> >
> > (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702 (a).

The shareholder's basis, once computed, limits the amount of losses and deductions that may be taken into account by a shareholder for the taxable year. Sec. 1366(d).

In memoranda filed with the Court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was "deferred" and not "tax-exempt income" under section 1366(a).

(Respondent did not argue that section 1367(b)(1) precluded an increase in basis with respect to income from discharge of indebtedness, presumably because, to the extent at issue here, such income was not required to be included on petitioners' returns.) At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:

> If the Court were to hold that excluded COD [cancellation (discharge) of indebtedness] is an item of income under Code section 1366, then you would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through * * *

We deal here solely with respondent's "final" position.

Respondent's position is based on section 1.61-12(a), Income Tax Regs., which states in part: "The discharge of indebtedness, in whole or in part, may result in the realization of income", and on section 1.61-12(b), Income Tax Regs., which states in part: "Income is not realized by a taxpayer * * * by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter, the taxpayer's liabilities exceed the value of his assets."

Section 1.61-12(b), Income Tax Regs., adopted by T.D. 6272, 1957-2 C.B. 18, 31, restates the pre-section 108 judicially created insolvency exception. See, e.g., *Estate of Delman v. Commissioner*, 73 T.C. 15, 32 (1979). Section 108 codified the insolvency exception as an exclusion from gross income. Bankruptcy Tax Act of 1980, Pub. L. 96-589, sec. 2, 94 Stat. 3389. Section 108(e)(1) provides that "there shall be no insolvency exception from the general rule

that gross income includes income from the discharge of indebtedness", except as provided in section 108. Thus, section 108, not section 1.61-12(b), Income Tax Regs., controls in these cases.

Respondent would have us treat differently the operation of sections 61(a)(12) and 108 and, for example, sections 61(a)(4) and 103 (relating to interest) or sections 61(a)(10) and 101 (relating to insurance). Respondent argues that, as an illustration, death benefits are first realized under section 61(a)(10) and then certain death benefits are excluded, i.e., not recognized, by section 101. Respondent argues that no such realization occurs in the case of discharge of indebtedness.

Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, section 61(a)(12) requires that income from discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Sec. 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items of income so excluded. Sec. 108 (a) (1) (A), (3).

Based on the foregoing, we hold that discharge of indebtedness is an "item of income" for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under section 61 (a) (12).

On the basis of the record, respondent's motions for summary judgment will be denied, and petitioners' cross-motions for partial summary judgment will be granted.

To reflect the foregoing,

Appropriate orders will be issued.

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

DAVID A. GITLITZ; LOUISE A. GITLITZ,	)	
Petitioners – Appellants,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	No. 98-9009
Respondent – Appellee.	)	
and	)	
PHILIP D. WINN; ELEANOR G. WINN,	)	
Petitioners – Appellants,	)	No. 98-9010
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent – Appellee.	)	

ORDER

Filed November 3, 1999

Before **TACHA, MAGILL,*** and **BRISCOE**, Circuit Judges.

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* Honorable Frank J. Magill, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

Appellants' petition for rehearing is denied.

The suggestion for rehearing en banc was transmitted to all of the judges of the court who are in regular active service as required by Fed. R. App. P. 35. As no member of the panel and no judge in regular active service on the court requested that the court be polled, the suggestion is also denied.

Entered for the Court
PATRICK FISHER, Clerk of Court

by: /s/ Illegible
Deputy Clerk

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26 U.S.C. § 108. Income from discharge of indebtedness

(a) Exclusion from gross income

(1) In general

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if –

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness, or

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

(2) Coordination of exclusions

(A) Title 11 exclusion takes precedence

Subparagraphs (B), (C), and (D) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(3) Insolvency exclusion limited to amount of insolvency

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes

(1) In general

The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction

Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL

Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit

Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit

The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers

Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction

(i) In general

The basis of the property of the taxpayer.

(ii) Cross reference

For provisions for making the reduction described in clause (i) see section 1017.

(F) Passive activity loss and credit carryovers

Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers

Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction

(A) In general

Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction

The reductions described in subparagraphs (B), (C), and (G) shall be 33 1/3 cents for each dollar excluded by subsection(a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 1/3 cents for each dollar excluded by subsection (a).

(4) Ordering rules

(A) Reductions made after determination of tax for year

The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (D) of paragraph (2)

The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

(C) Reductions under subparagraphs (B) and (G) of paragraph (2)

The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

(5) Election to apply reduction first against depreciable property

(A) In general

The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

(B) Limitation

The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced

Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) Treatment of discharge of qualified real property business indebtedness

(1) Basis reduction

(A) In general

The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference

For provisions making the reduction described in subparagraph (A), see section 1017.

(2) Limitations

(A) Indebtedness in excess of value

The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of –

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation

The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness

The term "qualified real property business indebtedness" means indebtedness which –

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(C) with respect to which such taxpayer makes an election to have this paragraph apply.

Such term shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced.

(4) Qualified acquisition indebtedness

For purposes of paragraph (3)(B), the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

(5) Regulations

The Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) Meaning of terms; special rules relating to certain provisions

(1) Indebtedness of taxpayer

For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness –

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case

For purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent

For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market

value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. ((4) Repealed. Pub. L. 99-514, title VIII, Sec. 822(b)(3)(A), Oct. 22, 1986, 100 Stat. 2373)

(5) Depreciable property

The term "depreciable property" has the same meaning as when used in section 1017.

(6) Certain provisions to be applied at partner level

In the case of a partnership, subsections (a), (b), (c), and (g) shall be applied at the partner level.

(7) Special rules for S corporation

(A) Certain provisions to be applied at corporate level

In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level.

(B) Reduction in carryover of disallowed losses and deductions

In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2)

For purposes of subsection (e)(6), a shareholder's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate

In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.

(A) Time

An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent

An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

(C) Manner

An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference

For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency)

For purposes of this title –

(1) No other insolvency exception

Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions

No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount

The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor

(A) Treated as acquisition by debtor

For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the

Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family

For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related

For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

(5) Purchase-money debt reduction for solvent debtor treated as price reduction If –

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur –

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital

Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital –

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

(7) Recapture of gain on subsequent sale of stock

(A) In general

If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245 –

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor –

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange, shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers

In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation

For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation

For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(E) Partnership rule

Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing

subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporation's stock

For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

(10) Indebtedness satisfied by issuance of debt instrument

(A) In general

For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price

For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption

price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(f) Student loans

(1) In general

In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan

For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by –

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation –

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made –

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

(3) Exception for discharges on account of services performed for certain lenders

Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

(g) Special rules for discharge of qualified farm indebtedness

(1) Discharge must be by qualified person

(A) In general

Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person

For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness

For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if –

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets

(A) In general

The amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed the sum of –

(i) the adjusted tax attributes of the taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(B) Adjusted tax attributes

For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D), (F), and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (b)(2) and the attribute described in subparagraph (F) of subsection (b)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified property

For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

(D) Coordination with insolvency exclusion

For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (b) by reason of amounts excluded from gross income under subsection (a)(1)(B).

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26 U.S.C. § 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability

(1) In general

In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's –

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined

For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru

The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or

incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder

In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions

(1) Cannot exceed shareholder's basis in stock and debt

The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of –

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions

Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(3) Carryover of disallowed losses and deductions to post-termination transition period

(A) In general

If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock

The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock

The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations

To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(e) Treatment of family group

If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without

receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules

(1) Subsection (a) not to apply to credit allowable under section 34

Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(2),Treatment of tax imposed on built-in gains

If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

(3) Reduction in pass-thru for tax imposed on excess net passive income

If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as –

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

* * *

26 U.S.C. § 1367. Adjustments to basis of stock of shareholders, etc.

(a) General rule

(1) Increases in basis

The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis

The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

(b) Special rules

(1) Income items

An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness

(A) Reduction of basis

If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis

If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d)

This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock

(A) In general

If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis

The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

UNITED STATES TAX COURT

DAVID A. and LOUISE A. GITLITZ,	)	
Petitioners,	)	DOCKET NO.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

PETITION

Petitioners hereby petition for a redetermination of the deficiency as set forth by the Commissioner of Internal Revenue in her Notice of Deficiency dated January 10, 1996, and, as a basis for their case, allege as follows:

1. Petitioners David A. and Louise A. Gitlitz's mailing address is P.O. Box 1774, Aspen, Colorado 81611. Petitioners' legal residence is at 0845 Red Mountain Rd., Aspen, Colorado 81612. Petitioner David A. Gitlitz's taxpayer identification number is 045-42-6651. Petitioner Louise A. Gitlitz's taxpayer identification number is 259-72-4465. A joint tax return for the year ending December 31, 1991 was filed with the Internal Revenue Service Center in Ogden, Utah.

2. The Notice of Deficiency (a copy of which, including the statements and schedules accompanying the Notice, is attached hereto as Exhibit A) was mailed to

Petitioners on January 10, 1996, and was issued by the District Director of the Internal Revenue Service at Denver, Colorado.

3. The deficiency as determined by the Commissioner, is as follows:

TAX YEAR ENDED	TAX
December 31, 1991	$251,192

4. The determination of tax as set forth in the Notice of Deficiency is based upon the following errors:

a. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed an ordinary loss of $1,010,648 due to a lack of basis pursuant to Section 1366 (d) (1) of the Internal Revenue Code.

b. The Commissioner erred when she determined in her Notice of Deficiency that, because of the change in the amount of gross income resulting from the disallowance of the loss, a total itemized deduction of $419,493 is allowable, instead of the $449,812 as shown on the return.

5. The facts upon which Petitioners rely as the basis for their case are as follows:

a. Petitioner David A. Gitlitz was a shareholder of P.D.W. & A., Inc., a Colorado corporation, holding a 50% interest in the corporation.

b. P.D.W. & A., Inc. was a calendar year taxpayer.

c. P.D.W. & A., Inc. had properly and effectively elected to be taxed as an "S Corporation" under the provisions of Subchapter S of the Internal Revenue Code prior to 1991, and that election was effective during the year ending December 31, 1991.

d. P.D.W. & A., Inc. was a partner in Parker Properties Joint Venture.

e. Parker Properties Joint Venture realized $4,154,891 in cancellation of indebtedness income in 1991.

f. P.D.W. & A., Inc.'s distributive share of Parker Properties joint Venture's cancellation of indebtedness income in 1991 was $2,021,296.

g. At the time that Parker Properties Joint Venture realized this income, P.D.W. & A., Inc. was insolvent to the extent of $2,181,748.

h. Pursuant to Section 1367 (a) (1) of the Internal Revenue Code of 1986, Petitioner David A. Gitlitz was required to increase his basis in his P.D.W. & A., Inc. stock by the amount of his pro rata share of the cancellation of indebtedness income realized by P.D.W. & A., Inc.

i. Petitioner David A. Gitlitz's basis in his P.D.W. & A., Inc. stock, as properly computed, entitled him to take into account an ordinary loss in the amount of $1,010,648.

j. Therefore, the Commissioner incorrectly determined that Petitioner was not entitled to an ordinary loss in the amount of $1,010,648 pursuant to the basis limitation rules of Section 1366 (d) (1) of the Internal Revenue Code of 1986.

WHEREFORE, Petitioners pray that this Court may hear this case and determine that:

1. There is no deficiency in tax for the taxable year ending December 31, 1991;

2. The Commissioner erred in the statutory notice of Deficiency as alleged in each assignment of error set forth in this Petition;

3. The court grant such other and further relief to which Petitioners may be entitled.

DATED this 22nd day of March, 1996.

CHICOINE & HALLETT, P.S.

/s/ Darrell D. Hallett
Darrell D. Hallett, #HD0353

/s/ Larry N. Johnson
Larry N. Johnson, #JL0062

/s/ Robert J. Chicoine
Robert J. Chicoine, #CR0714

/s/ John M. Colvin
John M. Colvin, #CJ1464

1011 Western Avenue
Waterfront Place One, Suite 803
Seattle, Washington 98104
(206) 223-0800

illegible
District Director
Date: JAN 10 1996

Person to Contact:
L. Sandoval
Contact Telephone Number:
(303) 446-1306

Robert J Guerra
56550 Greenwood Plaza Blvd
Ste 107
Englewood, CO 80111

The enclosed material is furnished to you under the provisions of a power of attorney of other authorization you have on file with us. For our convenience we have listed below the name(s) of the taxpayer(s) to whom this material relates.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely Yours,

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

Enclosures:
Letters
Reports

Taxpayer(s)' Name(s):

David A Gitlitz
and Louise A Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

David A Gitlitz
and Louise A Gitlitz
0845 Red Mountain Rd
Aspen, CO 81612

DEPARTMENT OF THE TREASURY
Internal Revenue Service
District Director

Date of This Notice:
Jan 10 1996
Letter Number 531
Taxpayer Identification Number:
045-42-6651
Form: 1040

David A Gitlitz
and Louise A. Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

CERTIFIED LETTER

1321136

-NOTICE OF DEFICIENCY-

Dear Taxpayer:

We were unable to reach a satisfactory agreement in your case. This letter is your **NOTICE OF DEFICIENCY** as required by law. Our determination shows that you are liable for a deficiency (increase) in tax as follows:

TAX YEAR ENDED	DEFICIENCY	ADDITIONS TO THE TAX
December 31, 1991	$ 251,192	

The enclosed schedule of Income Tax Examination Changes shows how the deficiency was computed.

IF YOU AGREE with these deficiencies and which to limit the amount of interest,

1. Sign and date the enclosed waiver Form 807.
2. Return the signed waiver from to us in the enclosed envelope.

You will limit the amount of interest if you enclose payment with your signed waiver form. Any unpaid liability will continue to be charged interest.

IF YOU DO NOT AGREE with these deficiencies you may,

1. Petition the United States Tax Court for a redetermination of the deficiencies. You may receive a petition form by writing to:

   United States Tax Court
   400 Second Street, NW
   Washington, DC 20217

2. Send the completed petition form with a copy of this letter to the United States Tax Court. You must file your petition within 90 days from the above mailing date (150 days if addressed to you outside the United States). The time for filing a petition is fixed by law, and the court cannot consider your case if the petition is filed late.
3. If both of you wish to petition the Tax Court, both must sign the petition or each must file a separate, signed petition.

You may represent yourself before the Tax Court, or you may be represented by anyone admitted to practice before the Court.

If you decide not to sign and return the waiver, and you do not file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the liability after 90 days from the mailing date of this letter (150 days if addressed to you outside of the United States).

If you have any questions about this letter, please call L. Sandoval at (303) 446-1306. If you wish to write us, please use the address below:

Internal Revenue Service
600 17th Street
MS4803DEN
Denver, CO 80202-2490

Please attach a copy of this letter to help us identify your account and include your telephone number and a convenient time for us to contact you if additional information is needed.

Sincerely,

Commissioner
By: /s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

cc: Robert J Guerra

Form 870

Department of the Treasury – Internal Revenue Service
Waiver of Restrictions on Assessment
and Collection of Deficiency in Tax and
Acceptance of Overassessment

Date received by IRS _____

Names and address of taxpayers
David A Gitlitz
and Louise A Gitlitz
5575 DTC Parkway Ste 360
Englewood, CO 80111

Social security or employer identification number
045-42-6651

Increase (Decrease) in Tax and Penalties

Tax Year Ended:	December 31, 1991
Deficiency:	
Increase in tax	$ 251,192

* * *

Instructions for Form 870

General Information

If you consent to the assessment of the deficiencies shown in this waiver, please sign and return the form in order to limit any interest charge and expedite the adjustment to your account. Your consent will not prevent you from filing a claim for refund (after you have paid the

tax) if you later believe you are so entitled. It will not prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

We have agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the required State form.

If you later file a claim and the Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

We will consider this waiver a valid claim for refund or credit of any overpayment due you resulting from any decrease in tax and penalties determined by the Internal Revenue Service, shown above, provided you sign and file it within the period established by law for making such a claim.

Who must sign

If you filed jointly, both you and your spouse must sign. If this waiver is for a corporation, it should be signed with the corporation name, followed by the signatures and titles of the corporate officers authorized to sign. An attorney or agent may sign this waiver provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, should, unless previously filed, accompany this form.

Department of the Treasury – Internal Revenue Service
Income Tax Examination Changes

Name and Address of Taxpayer

GITLITZ, DAVID A. & LOUISE A.
5575 DTC PARKWAY, STE 360

ENGLEWOOD CO 80111-

SS OR ❑ Number: 945-12-6651

Return Form No. 1040

Person with union examination changes were discussed

Name and Title

1.	Adjustments to Income	Tax Year End 12/31/91
A.	ITEMIZED DEDUCTIONS	$ 30,319.00
B.	POWER ALLOWED ORD LOSSES	1,010,648.00
	* * *	
2.	Total Adjustments	1,040,967.00

3.	Taxable Income Per Return or as Previously Adjusted	29,555.00
4.	Corrected Taxable Income	1,070,522.00
	Tax Method SCHEDULE D	
	Filing Status JOINT	
5.	Tax	295,333.00
6.	Additional Taxes	
7.	Corrected Tax Lability	295,333.00
8.	Less Credits	
A.	PRIOR YEAR MIN TAX CREDIT	12,921.00
B.		
C.		
D.		
9.	Balance (Line 7 less total of lines 8A through 8D)	282,412.00
10.	Plus Other Taxes	
A.	SELF EMPLOYMENT TAX	342.00
B.		
C.		
D.		
11.	Total Corrected Tax Liability (Line 9 + lines 10A to 10B)	282,754.00
12.	Total Tax Shown on Return or as Previously Adjusted	31,562.00

13. Adjustments to

A. SPECIAL FUELS CREDIT
B.

14. Deficiency – Increase in Tax or (Overassessment – Decrease in tax) (Line 11 less Line 12 adjusted by Line 13)
251,192.00

15. Adjustments to Prepayment Credits

16. Balance Due or Overpayment (Line 14 Adjusted by Line 15) (Excluding Interest and penalties)
$ 251,192.00

---

* * *

The Internal Revenue Service has agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the State form.

You may be subject to backup withholding if you underreport your interest, dividend, or patronage dividend income and do not pay the required tax. The IRS may order backup withholding at 31 percent after four notices have been issued to you over a 120-day period and the tax has been assessed and remain unpaid.

Summary of Taxes, Penalties and Interest:

A. Balance due or Overpayment of Taxes (line 16, page 1)

251.192.00

B. Penalties (line 18, page)
(Computed to 10/13/95)

C. Interest (IRC 6601)
(Computed to 10/13/95)

D. TMI Interest (computed to
10/13/95 on TMI underpayment)

E. Amount due or refund
(sum of lines A, B, C,
and D.) 251,192.00

Other Information:

Examiner's Signature
/s/ T McMahon
Theresa McMahon

District Denver

Date 09/13/95

TTES Ver. S3.94 Page 2 of 2 Form 4549A-C6 (Rev. 1-91)

David A Gitlitz
Louise A Gitlitz
90D:4803DEN

EXPLANATION OF ADJUSTMENTS
TAXABLE YEARS ENDING DECEMBER 31, 1991.

1A.

Due to the change in the amount of your adjusted gross income, a total itemized deduction of $419,493 is allowed instead of $449,812 as shown on your income tax return(s) for the taxable year(s) ended 1991. See exhibit A.

1B.

It is determined that you are not allowed an ordinary loss of $1,010,648 in tax years 1991 due to lack of basis under Internal Revenue Code Section 1366(d)(1).

EXHIBIT A 3013

Name Of Taxpayer: GITLITZ, DAVID A. & LOUISE 09/15/95
Identification Number: 045-42-5651 TOTAL 33.94

9112 SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	1,291.00	1,291.00	0.00
2. 0.075 of Adjusted Gross Income	35,953.00	111,751.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	54,324.00	54,324.00	0.00
5. Home Interest Expense	50,362.00	50,362.00	0.00
6. Investment Interest	224,054.00	224,054.00	0.00
7. Other Interest Expense	1,741.00	1,741.00	0.00
8. Total Interest Expense	276,157.00	276,157.00	0.00
9. Contributions	130,712.00	130,712.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	2,876.00	2,876.00	0.00
13. 0.020 of Adjusted Gross Income	9,587.00	29,800.00	
14. Excess Miscellaneous deductions	0.00	0.00	0.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15)	449,812.00	419,493.00	30,319.00

ITEMIZED DEDUCTIONS WORKSHEET

A.	Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	461,193.00
B.	Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	224,054.00
C.	Line A less Line B	237,139.00
D.	Multiply the amount on line C by 80%	189,711.00
E.	Adjusted Gross Income from Form 1040	1,490,015.00
F.	$100,000 (or $50,000 if married filing separate)	100,000.00
G.	Line E less Line F	1,390,015.00
H.	Multiply the amount on Line G by 3%	41,700.00
I.	Enter the smaller of Line D or Line H	41,700.00
J.	Total Itemized Deductions (entered on line 16 above)	419,493.00

BEST AVAILABLE COPY

UNITED STATES TAX COURT

PHILIP D. and ELEANOR G. WINN, Petitioners,	)	DOCKET NO.
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

PETITION

Petitioners hereby petition for a redetermination of the deficiency as set forth by the Commissioner of Internal Revenue in her Notice of Deficiency dated January 10, 1996, and, as a basis for their case, allege as follows:

1. Petitioners Philip D. and Eleanor G. Winn's legal residence is at 4941 Nassau Circle, Englewood, Colorado 80110. Petitioner Philip D. Winn's taxpayer identification number is 047-12-0453. Petitioner Eleanor G. Winn's taxpayer identification number is 122-16-0566. A joint tax return for the year ending December 31, 1992 was filed with the Internal Revenue Service Center in Ogden, Utah.

2. The Notice of Deficiency (a copy of which, including the statements and schedules accompanying the Notice, is attached hereto as Exhibit A) was mailed to Petitioners on January 10, 1996, and was issued by the District Director of the Internal Revenue Service at Denver, Colorado.

3. The deficiency as determined by the Commissioner, is as follows:

TAX YEAR ENDED	TAX
December 31, 1992	$ 242,555

4. The determination of tax as set forth in the Notice of Deficiency is based upon the following errors:

a. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed a capital passive activity loss carryover of $21,638 from P.D.W. & A., Inc. because of adjustments to Petitioners' 1991 return, because the loss exceeded Petitioners' basis in P.D.W. & A., Inc., and because Sections 108(b) and (d)(7) of the Internal Revenue Code of 1986 provide for a reduction in the capital loss carryover.

b. The Commissioner erred when she determined in her Notice of Deficiency that Petitioners are not allowed an ordinary passive activity loss carryover of $989,010 from P.D.W. & A., Inc. because of adjustments to Petitioners' 1991 return, because the loss exceeded Petitioners' basis in P.D.W. & A., Inc., and because Sections 108(b) and (d)(7) of the Internal Revenue Code of 1986 provide for a reduction in the passive activity loss carryover.

c. The Commissioner erred when she determined in her Notice of Deficiency that, because of the change in the amount of gross income resulting from the disallowance of the losses, a total itemized deduction of $193,085 is allowable, instead of the $236,816 as shown on the return.

5. The facts upon which Petitioners rely as the basis for their case are as follows:

a. Petitioner Philip D. Winn was a shareholder of P.D.W. & A., Inc., a Colorado corporation, holding a 50% interest in the corporation.

b. P.D.W. & A., Inc. was a calendar year taxpayer.

c. P.D.W. & A., Inc. had properly and effectively elected to be taxed as an "S Corporation" under the provisions of Subchapter S of the Internal Revenue Code prior to 1991, and that election was effective during the year ending December 31, 1991. Effective January 1, 1992, P.D.W. & A., Inc. revoked its S Corporation status.

d. P.D.W. & A., Inc. was a partner in Parker Properties Joint Venture.

e. Parker Properties Joint Venture realized $4,154,891 in cancellation of indebtedness income in 1991.

f. P.D.W. & A., Inc.'s distributive share of Parker Properties Joint Venture's cancellation of indebtedness income in 1991 was $2,021,296.

g. At the time that Parker Properties Joint Venture realized this income, P.D.W. & A., Inc. was insolvent to the extent of $2,181,748.

h. Pursuant to Section 1367(a)(1) of the Internal Revenue Code of 1986, Petitioner Philip D. Winn was required to increase his basis in his P.D.W. & A., Inc. stock by the amount of his pro rata share ($1,101,648) of the cancellation of indebtedness income realized by P.D.W. & A., Inc.

i. Petitioner Philip D. Winn's basis in his P.D.W. & A., Inc. stock, as properly computed, entitled him to take into account additional losses in the amount of $1,010,648.

j. Petitioners were not able to utilize $21,638 in capital losses and $989,010 in ordinary losses in 1991 because of passive activity loss limitations.

k. The disallowed ordinary loss in the amount of $989,000 and the disallowed capital loss in the amount of $21,638 were properly carried over and taken into account in 1992.

l. The Commissioner, therefore, incorrectly determined that Petitioners were not entitled to a capital passive activity loss carryover in the amount of $21,638 and an ordinary passive activity loss carryover in the amount of $989,010.

WHEREFORE, Petitioners pray that this Court may hear this case and determine that:

1. There is no deficiency in tax for the taxable year ending December 31, 1992;

2. The Commissioner erred in the statutory Notice of Deficiency as alleged in each assignment of error set forth in this Petition;

3. The Court grant such other and further relief to which Petitioners may be entitled.

DATED this 22nd day of March, 1996.

CHICOINE & HALLETT, P.S.

/s/ Darrell D. Hallett
Darrell D. Hallett, #HD0353

/s/ Larry N. Johnson
Larry N. Johnson, #JL0062

/s/ Robert J. Chicoine
Robert J. Chicoine #CR0714

/s/ John M. Colvin
John M. Colvin, #CJ1464

1011 Western Avenue
Waterfront Place One,
Suite 803
Seattle, Washington 98104
(206) 223-0800

Date: JAN 10 1996

Person to Contact: L. Sandoval
Contact Telephone Number: (303) 446-1306

Robert J Guerra
56550 Greenwood Plaza Blvd
Ste 107
Englewood, CO 80111

The enclosed material is furnished to you under the provisions of a power of attorney or other authorization you have on file with us. For your convenience we have listed below the name(s) of the taxpayer(s) to whom this material relates.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely Yours,

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr
District Director

Enclosures:
Letters
Reports

Taxpayer(s)' Name(s):

Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

Philip D Winn
and Eleanor G Winn
5445 DTC Parkway Ste 300
Englwood, CO 80111

Philip D Winn
and Eleanor G Winn
5475 DTC Parkway Ste 300
Englwood, CO 80111

DEPARTMENT OF THE TREASURY
Internal Revenues Service
District Director

Date of This Notice: JAN 10 1995
Letter Number 531
Taxpayer Identification Number:
047-12-0453
Form: 1040

Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

CERTIFIED LETTER
132/139

– NOTICE OF DEFICIENCY –

Dear Taxpayer:

We were unable to reach a satisfactory agreement in your case. This letter is your **NOTICE OF DEFICIENCY** as required by law. Our determination shows that you are liable for a deficiency (increase) in tax as follows:

TAX YEAR ENDED	DEFICIENCY
December 31, 1992	$242,555

ADDITIONS TO THE TAX

The enclosed schedule of Income Tax Examination Changes shows how the deficiency was computed.

IF YOU AGREE with these deficiencies and wish to limit the amount of interest,

1. Sign and date the enclosed waiver Form 870.

2. Return the signed waiver form to us in the enclosed envelope.

You will limit the amount of interest if you enclose payment with your signed waiver form. Any unpaid liability will continue to be charged interest.

IF YOU DO NOT AGREE with these deficiencies you may,

1. Petition the United States Tax Court for a redetermination of the deficiencies. You may receive a petition form by writing to:

   United States Tax Court
   400 Second Street, NW
   Washington, DC 20217

2. Send the completed petition form with a copy of this letter to the United States tax Court. You must file your petition within *90 days* from the above mailing date (150 days if addressed to you outside the United States). The time for filing a petition is fixed by law, and the court cannot consider your case if the petition is filed late.

3. If both of you wish to petition the Tax Court, both must sign the petition or each must file a separate, signed petition.

You may represent yourself before the Tax Court, or you may be represented by anyone admitted to practice before the Court.

If you decide not to sign and return the waiver, and you do not file a petition with the tax Court within the time limit, the law requires us to assess and bill you for the liability after 90 days from the mailing date of this letter

(150 days if addressed to you outside of the United States).

If you have any questions about this letter, please call L. Sandoval at (303) 446-1306. If you wish to write us, please use the address below:

Internal Revenue Service
600 17th Street
MS4803DEN
Denver, CO 80202-2490

Please attach a copy of this letter to help us identify your account and include your telephone number and a convenient time for us to contact you if additional information is needed.

Sincerely,

Commissioner
By:

/s/ Walter A. Hutton Jr.
Walter A. Hutton Jr.
District Director

cc: Robert J Guerra
James I Massaro

Form 870

Department of the Treasury – Internal Revenue Service
Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment

Date received by IRS

Names and address of taxpayers
Philip D Winn
and Eleanor G Winn
4941 Nassau Circle
Englewood, CO 80110

Social security or employer identification number
047-12-0453

Increase (Decrease) in Tax and Penalties

Tax Year Ended:	December 31, 1992
Deficiency:	
Increase in tax	$ 242,555

* * *

Instructions for Form 870

General Information

If you consent to the assessment of the deficiencies shown in this waiver, please sign and return the form in order to limit any interest charge and expedite the adjustment to your account. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled. It will not prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

We have agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the required State form.

If you later file a claim and the Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

We will consider this waiver a valid claim for refund or credit of any overpayment due you resulting from any decrease in tax and penalties determined by the Internal Revenue Service, shown above, provided you sign and file it within the period established by law for making such a claim.

Who must sign

If you filed jointly, both you and your spouse must sign. If this waiver is for a corporation, it should be signed with the corporation name, followed by the signatures and titles of the corporate officers authorized to sign. An attorney or agent may sign this waiver provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, an executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, should, unless previously filed, accompany this form.

FORM 4549-A RETURN FORM 1040

DEPT. OF THE TREASURY-INTERNAL
REVENUE SERVICE
INCOME TAX EXAMINATION CHANGES

Name and Address of Taxpayer
Philip D Winn
Eleanor G Winn
4941 Nassau Circle
Englewood CO 80110

TIN 047-12-0453

Filing Status Joint

Person With Whom Changes Were Discussed

1.	ADJUSTMENTS TO INCOME:	Year: 1992
	A. Capital Gain or loss	$21,638.00
	B. Itemized deductions	$43,731.00
	C. PAL – PDWA Passive Ordinary loss	$989,010.00
	* * *	
2.	TOTAL ADJUSTMENTS	$1,054,379.00
3.	TAXABLE INCOME PER RETURN	$1,239,965.00
4.	CORRECTED TAXABLE INCOME	$2,294,344.00
5.	TAX	$660,783.00
6.	ALTERNATIVE TAX, IF APPLICABLE (From Page ___)	
7.	CORRECTED TAX LIABILITY	$660,783.00
8.	LESS: CREDITS:	

A. General Business Credit	$94,637.00
B. Foreign Tax Credit	$19.00
C.	
9. BALANCE	$566,127.00
10. PLUS: ADDITIONAL TAXES	
A. Self-employment tax	
B.	
C.	
11. TOTAL CORRECTED TAX LIABILITY	$566,127.00
12. TOTAL TAX AS PREVIOUSLY ADJ	$323,572.00
13. DEFICIENCY (line 12-line 13)	$242,555.00
14. OVERASSESSMENT (line 13-line 12)	
15. ADJUSTMENT TO PREPAYMENT CREDITS	
16. BALANCE DUE, Not including interest	$242,555.00
17. OVERPAYMENT, Not including interest	
18. PENALTIES, IF ANY (see explanation)	

Other Information

Philip D Winn
Eleanor G Winn
90D:4803DEN

EXPLANATION OF ADJUSTMENTS
TAXABLE YEARS ENDING DECEMBER 31, 1992.

1A.
A deduction for a capital passive activity loss carryover of $21,638 from P.D.W.&A Inc. is disallowed due to the

adjustments to your tax return for 1991, the fact that the loss exceeded your basis in P.D.W.&A. Inc., and that 108(b) and (d)(7) provide for a reduction in the capital loss carryover. Accordingly, taxable income is increased $21,638. See exhibit A.

1B.

Due to the change in the amount of your adjusted gross income, a total itemized deduction of $193,085 is allowed instead of $236,816 as shown on your income tax return(s) for the taxable year(s) ended 1992. See exhibit B.

1C.

A deduction for an ordinary passive activity loss carryover of $989,010 from P.D.W.&A., Inc., is disallowed due to the adjustments to your tax return for 1991, the fact that the loss exceeded your basis in P.D.W.&A. Inc., and that 108(b) and (d)(7) provide for a reduction in the passive activity loss carryover. Accordingly, taxable income is increased $989,010.

8A.

You are entitled to the general tax credit as provided by section 42 of the Internal Revenue Code. Accordingly, your tax is decreased $94,637. See exhibit C for computation.

EXHIBIT A

Name of Taxpayer: WINN, PHILIP D. & ELEANOR
Identification Number: 047-12-0453 TOTAL

09/13/95
$3.94

9212 SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	66,036.00	
2. Short-term capital loss carryover	0.00	
3. Net Short-term Gain or Loss (Add line 1 and 2)		66,036.00
4. Long-term capital gain or loss	1,418,662.00	
5. Long-term capital loss carryover	21,638.00	
6. Net long-term Gain or Loss (Add line 4 and 5)		1,440,500.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss		1,506,536.00
8. Capital loss limitation		0.00
9. Capital Gain or Loss - As Corrected		1,506,536.00
10. Capital Gain or Loss - Per Return		1,484,898.00
11. Line 9 less line 10 - Adjustment to Income		21,638.00

CORRECTED CARRYOVER

12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00

COMPUTATION OF ALTERNATIVE TAX

14. Taxable Income	2,294,344.00
15. Lesser of Long-Term Gain or Net Capital Gain	1,440,500.00
16. Line 14 less line 15	853,844.00
17. Alternative amount based on filing status	35,900.00
18. Greater of line 16 or line 17	853,844.00
19. Line 14 less line 18	1,440,500.00
20. Tax on line 18 using Rate Schedule	257,443.00
21. Line 19 multiplied by 28%	403,340.00
22. Line 21 plus line 20 - Alternative Capital Gain Tax	660,783.00

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Name Of Taxpayer: WINN, PHILIP D. & ELEANOR 09/13/95
Identification Number: 047-12-0453 TOTAL 53.94

9212 SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	501.00	501.00	0.00
2. 0.075 of Adjusted Gross Income	110,759.00	186,557.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	46,988.00	46,988.00	0.00
5. Home Interest Expense	0.00	0.00	0.00
6. Investment Interest	62,284.00	62,284.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	62,284.00	62,284.00	0.00
9. Contributions	155,278.00	155,278.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	42,948.00	42,948.00	0.00
13. 0.020 of Adjusted Gross Income	29,536.00	49,749.00	
14. Excess Miscellaneous deductions	13,412.00	0.00	13,412.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15)	236,816.00	193,085.00	43,731.00

ITEMIZED DEDUCTIONS WORKSHEET

A.	Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	264,550.00
B.	Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	62,284.00
C.	Line A less Line B	202,266.00
D.	Multiply the amount on line C by 80%	161,813.00
E.	Adjusted Gross Income from Form 1040	2,487,429.00
F.	$105,250 (or $52,625 if married filing separate)	105,250.00
G.	Line E less Line F	2,382,179.00
H.	Multiply the amount on Line G by 3%	71,465.00
I.	Enter the smaller of Line D or Line H	71,465.00
J.	Total Itemized Deductions (entered on line 16 above)	193,085.00

9212 FORM 3900 - GENERAL BUSINESS CREDIT

1.	Tentative Investment Credit	0.00
2.	Tentative Jobs Credit	0.00
3.	Tentative Alcohol Used as Fuel Credit	0.00
4.	Tentative Research Activities Credit	0.00
5.	Tentative Low Income Housing Credit	63,360.00
6.	Tentative Enhanced Oil Recovery Credit	0.00
7.	Tentative Disabled Access Credit	0.00
8.	Tentative Renewable Electricity Production Credit	0.00
9.	Current Year General Business Credit	63,360.00
10.	Passive Activity Credits included in lines 1 through 8	63,360.00
11.	Subtract line 10 from line 9	0.00
12.	Passive Activity Credits allowed in 1992	271,092.00
13.	Carrybacks and Carryovers	45,219.00
14.	Total Available Credit subject to Limitation	316,311.00
15.	Income Tax liability as adjusted	660,764.00
16.	General Business Credit Limitation	660,764.00
17.	General Business Credit as Corrected	94,637.00
18.	General Business credit available for carryover or carryback	221,674.00

Filed January 27, 2000

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 99-3209

UNITED STATES OF AMERICA

v.

HAROLD D. FARLEY;
GAIL D. FARLEY,

Appellants

Appeal from the United States District Court
for the Western District of Pennsylvania
(D.C. Civil Action No. 97-cv-00308E)
District Judge: Honorable Maurice B. Cohill, Jr.

Argued October 28, 1999

Before: MANSMANN, ROTH, and WEIS, Circuit Judges

(Opinion filed January 27, 2000)

Harry Litman, Esquire
United States Attorney
Loretta C. Argrett, Esquire
Assistant Attorney General
Teresa E. McLaughlin, Esquire
Edward T. Perelmuter, Esquire
(Argued)
Annette M. Wietecha, Esquire
United States Department of Justice
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Attorneys for Appellee

Joseph J. Haspel, Esquire (Argued)
Stein, Riso, Haspel & Jacobs
254 South Main Street
New City, NY 10956

Attorney for Appellants

OPINION OF THE COURT

ROTH, Circuit Judge:

This case presents a question of statutory interpretation; its facts are not disputed. The appellants, Harold and Gail Farley, are taxpayers and owners of two separate S corporations. The Farleys obtained income tax refunds from the Internal Revenue Service in late 1995 and early 1996 after filing amended tax returns for the years 1989, 1990, 1992 and 1993. They obtained these refunds after adjusting the basis of their S corporation stock upward to account for discharge of indebtedness income excluded from gross income due to the insolvency of their S corporations. By increasing the basis of their S corporation stock, the Farleys were able to take deductions for losses that had been previously suspended. The recognition of these suspended losses resulted in a reduction of the Farley's tax liability for 1989, 1990, 1992 and 1993. In addition, through the same increase in basis, the Farleys were able to take advantage of losses in 1995 resulting in an additional reduction of tax liability. The I.R.S. issued refunds, reflecting these adjustments, but later decided that the Farleys could not utilize discharge of indebtedness income to increase the basis of their S corporation stock. As a consequence, the I.R.S. concluded that the

Farleys were not entitled to deductions for their suspended losses and thus were not entitled to the refunds issued in late 1995 and early 1996.

The Government subsequently brought suit in District Court to recover these refunds. Both parties moved for summary judgment. The District Court, relying primarily on *Nelson v. Commissioner*, 110 T.C. 114 (1998), granted the Government's motion for summary judgment. The Farleys appeal the District Court's grant of summary judgment.

Because we find that the District Court misinterpreted the relevant statutes in disallowing the refunds obtained by the Farleys, we will reverse the grant of summary judgment and remand this case to the District Court to enter judgment in favor of the Farleys.

I. FACTS

In 1986, the Farleys invested $200,000 and received fifty percent of the stock of two S corporations, SCI Acquisition, Inc. ("SCI") and CCI Camping Corporation ("CCI") (hereinafter referred to collectively as the "Farley S Corporations"). In 1986 and 1987, the Farley S Corporations incurred losses, which for tax purposes passed through to the Farleys. *See* 26 U.S.C. § 1366(a)(1) ("In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's . . . items of income (including tax-exempt income), loss, deduction, or credit the separate treatment

of which could affect the liability for tax of any shareholder . . . . ").[1] As a result of these losses, by the end of the 1987 tax year, the Farleys' S corporation stock had a zero basis.[2] From 1987 through 1992, the Farley S Corporations continued to incur losses. Because the Farleys' S corporation stock had a zero basis, the Farleys reported these losses as suspended losses on their tax returns (the

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[1] The concept of "pass-through" provides to S corporation shareholders some of the advantages of a partnership. It is perhaps best summarized by the following excerpt from a recent Tenth Circuit opinion: Subchapter S of the Internal Revenue Code, 26 U.S.C. §§ 1361-1379, permits certain corporations to elect to be taxed in a similar, but not identical, fashion as partnerships. *See* 3 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts P 95.6.1 (2d ed. 1991) (highlighting major distinctions). A subchapter S corporation generally does not pay taxes as an entity. 26 U.S.C. § 1363(a). Instead, the corporation's profits and losses pass through directly to its shareholders on a pro rata basis and are then reported on the shareholders' individual tax returns. 26 U.S.C. § 1366(a). This conduit approach allows shareholders to avoid double taxation on corporate earnings. Tax integrity, meanwhile, is preserved by requiring shareholders to treat all income and deductions as if "realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." 26 U.S.C. § 1366(b). *Gitlitz v. Commissioner*, 182 F.3d 1143, 1146 (10th Cir. 1999).

[2] The tax basis of an asset, in this case the Farleys' S corporation stock, is typically the asset's cost. To determine the basis of an S corporation's stock, a taxpayer starts with the cost of the stock and increases his or her basis for corporate income and loans to the corporation. *See* 26 U.S.C. § 1367(a)(1). Similarly, the taxpayer decreases his or her basis for corporate losses and distributions by the corporation. *See* 26 U.S.C. § 1367(a)(2). It was this deduction of corporate losses from basis which had reduced the Farley's S corporation stock to zero basis.

"Suspended Losses"). *See* 26 U.S.C. § 1366(d)(1)(A) ("[The] aggregate amount of losses and deductions taken into account by a shareholder under [§ 1366(a)] for any taxable year shall not exceed . . . the adjusted basis of the shareholder's stock in the S corporation."); 26 U.S.C. § 1366(d)(2) ("Any loss or deduction which is disallowed for any taxable year by reason of [§ 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.").

In 1992, the Farley S Corporations ceased operating due to their continued losses, and, as a result, the Farley S Corporations' secured creditors foreclosed on the assets of SCI and CCI. All debt not satisfied by the sale of these assets was forgiven by the secured creditors, resulting in discharge of indebtedness income (also known as cancellation of debt income) to the Farley S Corporations (the "COD Income"). From this point on, the Farley S Corporations were insolvent, and, as such, the COD Income was excluded from gross income. *See* 26 U.S.C. § 108(a)(1)(B).

On or around April 15, 1990, the Farleys filed their income tax return for the 1989 tax year. The 1989 Return disclosed a tax liability of $67,507, which the Farleys paid. On or around April 15, 1991, the Farleys filed their income tax return for the 1990 tax year. The 1990 Return disclosed a tax liability of $112,553, which the Farleys paid. On or around April 15, 1993, the Farleys filed their income tax return for the 1992 tax year. The 1992 Return disclosed a tax liability of $42,936, which the Farleys paid. On or around April 15, 1994, the Farleys filed their income tax return for the 1993 tax year. The 1993 Return disclosed a tax liability of $44,748, which the Farleys

paid. Finally, on or around October 11, 1996, the Farleys filed their income tax return for the 1995 tax year. The 1995 Return disclosed a tax liability of $0.

On September 1, 1995, and January 12, 1996, the Farleys filed amended tax returns for tax years 1989, 1990, 1992 and 1993 (together, the "Relevant Tax Years"). As a part of the Amended Returns, the Farleys claimed refunds for the Relevant Tax Years as follows: 1989 – $67,507; 1990 – $64,522; 1992 – $42,936; and 1993 – $44,748.

The Amended Returns were premised on an increase in the tax basis of the Farleys' S corporation stock as a consequence of COD income. Through this increase in tax basis, the Farleys were able to recognize the Suspended Losses and consequently reduced their tax liability for each of the Relevant Tax Years. In addition, through the same increase in basis, the Farleys were able to take deductions for losses in the 1995 tax year. The I.R.S. issued refunds in the amounts claimed by the Farleys (the "Relevant Refunds").

Shortly thereafter, in two undated letters (the "30 Day Letters") from Frank P. Nixon, District Director of the I.R.S., by I.R.S. Agent Robert V. Grosso, the I.R.S. proposed certain assessments. Along with the 30 Day Letters, the Farleys were provided with a series of reports authored by Grosso, which concluded that the Relevant Refunds were erroneously issued and therefore the Refund Claims were disallowed. According to the Grosso Reports, pursuant to the controlling statutes, the Farleys could not increase the tax basis of their S corporation

stock even though the Farley S Corporations had discharge of indebtedness income; they could not, therefore, recognize the Suspended Losses; and ultimately they could not claim refunds for the Relevant Tax Years nor take a deduction for the losses in 1995.

The 30 Day Letters proposed tax liability as follows: 1989 - $67,507; 1990 - $64,522; 1992 - $42,918; 1993 - $44,748; and 1995 - $92,980. By agreement between Grosso and the Farleys' accountant, the parties set July 31, 1997, as the last day to protest the issues raised by the 30 Day Letters. The Farleys promptly protested the assessments in the 30 Day Letters, and shortly thereafter the Government brought suit in U.S. District Court for the Western District of Pennsylvania seeking recovery of the Relevant Refunds.

In District Court, the Farleys moved for summary judgment, and the Government cross-moved for summary judgment. In their initial motion for summary judgment, the Farleys relied primarily upon *Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997) (*Winn I*). *Winn I* was squarely on point and supported the Farleys' position, but the Tax Court chose to re-visit the issue en banc in a different case, *Nelson v. Commissioner*, that presented the same question. After re-visiting the issue, the Tax Court's opinion in *Winn I* was withdrawn and superseded by a subsequent opinion issued the same day as the Tax Court's opinion in *Nelson v. Commissioner*. *See Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997) withdrawn and superseded by *Winn v. Commissioner*, 75 T.C.M. (CCH) 1840 (1998); *Nelson v. Commissioner*, 110 T.C. 114, 130 (1998). Relying on *Nelson*, which was affirmed by the Tenth Circuit Court of Appeals, the District Court in this case granted the Government's

motion for summary judgment. *See United States v. Farley*, 99-1 U.S.T.C. ¶ 50, 370 (1999); *see also Nelson v. Commissioner*, 182 F.3d 1152, 1152-53 (10th Cir. 1999) ("For the same reasons outlined in our published opinion filed today in *Gitlitz v. Commissioner* . . . we affirm the decision of the Tax Court."); *Gitlitz v. Commissioner*, 182 F.3d 1143, 1151 (10th Cir. 1999) (holding that discharge of indebtedness income excluded from gross income under 26 U.S.C. § 108(a) does not pass through to the shareholders of an S Corporation and thus does not increase the shareholder's basis in their S corporation stock). The Farleys appeal the District Court's ruling.

II. JURISDICTION

This action was filed by the Government pursuant to § 7405(b) of the Internal Revenue Code. Section 7405(b) of the Internal Revenue Code provides the Government with a civil cause of action to recover taxes "erroneously refunded." 26 U.S.C. § 7405(b); *see, e.g., Hutchins v. Internal Revenue Service*, 67 F.3d 40, 42 (3d Cir. 1995).

The District Court had subject matter jurisdiction over this case pursuant to 28 U.S.C. § 1331 (1999), and we have appellate jurisdiction pursuant to 28 U.S.C. § 1291 (1999). *See* 28 U.S.C. § 1331 (1999) ("The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."); 28 U.S.C. § 1291 (1999) ("The courts of appeals . . . shall have jurisdiction of appeals from all final decisions of the district courts of the United States. . . . "). Our review of the District Court's grant of summary judgment is plenary. *See, e.g., Hurley v. Atlantic City Police Dept.*, 174 F.3d 95, 128 n.29 (3d Cir. 1999).

III. DISCUSSION

A. Recovery of Refunds Under Section 7405(b)

Before reaching the merits of the taxpayers' argument, we address the Farleys' contention that the Government cannot sue pursuant to 26 U.S.C. § 7405(b) to recover the Relevant Refunds. Section 7405(b) states in pertinent part that "[a]ny portion of a tax imposed by this title which has been erroneously refunded . . . may be recovered by civil action brought in the name of the United States." 26 U.S.C. § 7405(b). Noting that "[t]here has never been any assertion that [the Relevant Refunds] were mistakenly issued," the Farleys argue that the Relevant Refunds were not "erroneously refunded" within the meaning of the statute and that the Government therefore cannot sue to recover the Relevant Refunds pursuant to § 7405(b). Instead, the Farleys contend, the Government must proceed under 26 U.S.C. § 6212 to recover the Relevant Refunds. The Farleys argue that "[t]he facts of this case are squarely on point with the facts of *United States v. Russell Mfg. Co.*, 349 F.2d 13 (2d Cir. 1965)," and as such the Government is precluded by the holding in *Russell* from suing to recover the Relevant Refunds pursuant to 26 U.S.C. § 7405(b). While the Farleys' argument is not entirely without merit, we conclude that the Government can bring suit pursuant to § 7405(b) to recover the Relevant Refunds. In addition, while we are obviously not bound by Second Circuit precedent, it is important to note that even if we were to adopt the reasoning of the Russell court, the Farleys' argument still fails because the facts of this case are not "squarely on point with the facts of" *Russell*.

The controversy that gave rise to *United States v. Russell Mfg. Co.* began in 1945 when Russell Manufacturing Company took a $47,200 deduction for payments made to two separate trusts. *Russell*, 349 F.2d at 15. The Commissioner of Internal Revenue disallowed the deduction, concluding that:

> [The] payments were not pursuant to a "qualified" plan under § 23(p)(1)(A), (B) and (C) of the 1939 Code . . . and that they did not meet the requirement of § 23(p)(1)(D) which permits deductions of payments under a non-qualified plan "if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid."

Id. Upon denial of the refund claim, Russell Manufacturing sued in the Court of Claims and ultimately prevailed. *See Russell Mfg. Co. v. United States*, 175 F. Supp. 159, 163 (Ct. Cl. 1959).

After prevailing in the Court of Claims, Russell Manufacturing continued to claim similar refunds for many years. The I.R.S. issued these refunds but decided in 1964 to bring suit in the District Court pursuant to § 7405(b) to recover the refunds, alleging that the refunds had been issued erroneously. *See United States v. Russell Mfg. Co.*, 245 F. Supp. 159 (D. Conn. 1964). The District Court dismissed the Government's claim, concluding that the Government could not sue under § 7405(b) because the money claimed by the Government had not been "erroneously refunded." *See id.* at 160. The Government promptly appealed the District Court's ruling, and the Second Circuit affirmed, concluding that the Government

could not sue pursuant to § 7405(b). *See Russell*, 349 F.2d at 19. The facts of *Russell*, however, differ dramatically from the facts in this case.

Unlike this case, in *Russell*, the Government "candidly" admitted that "[i]ts aim [was] to obtain a decision by [the Second Circuit Court of Appeals] conflicting with that of the Court of Claims, as to which Russell might well obtain certiorari under Supreme Court Rule 19, subd. 1(b), and thus to procure an authoritative construction, hopefully in the Government's favor." *Russell*, 349 F.2d at 16. In addition, unlike this case, the parties in *Russell* were the same in the Court of Claims as in the Court of Appeals. In arguing that the facts of this case are "squarely on point with the facts of *United States v. Russell Manufacturing Co.*, 349 F.2d 13 (2nd Cir. 1965)," the Farleys analogize the earlier Court of Claims decision in *Russell* to the Tax Court's initial decision in *Winn v. Commissioner*. In *Russell*, the taxpayer in the Court of Claims and the Second Circuit Court of Appeals was the same – Russell Manufacturing Company. In contrast, the taxpayers in *United States v. Farley* (Third Circuit Court of Appeals) and *Winn v. Commissioner* (Tax Court) were clearly different. The final and perhaps most important point is that the court in *Russell* explicitly limited its holding to the facts of that case stating, "[w]e limit our decision to the unusual facts here presented, where the Government deliberately made what it then considered an erroneous refund to a taxpayer prevailing in a court decision whose authority remains unimpaired." *Russell*, 349 F.2d at 17-18 (emphasis added). The Farleys' reliance on *Russell* is misplaced; *Russell* is inapposite because the

Government in this case did not change its treatment of tax refunds in order to prompt litigation.

Indeed, this case is more appropriately analogized to *United States v. Ellis*, 154 F. Supp. 32 (S.D.N.Y. 1957), *aff'd* 264 F.2d 325 (2d Cir. 1959), *United States v. Heilbroner*, 22 F. Supp. 368 (S.D.N.Y. 1938) *aff'd* 100 F.2d 379 (2d Cir. 1938), or *United States v. Tuthill Springs Co.*, 55 F.2d 415 (N.D. Ill. 1931) in which the I.R.S. changed its interpretation of the substantive law. However, unlike *Russell*, in *Ellis*, *Heilbroner*, and *Tuthill*, the court held that the Government could sue under the predecessor of § 7405(b) to recover refunds erroneously issued. As such, we conclude that the Government can bring this suit under § 7405(b) of the Internal Revenue Code in an effort to recover the Relevant Refunds.

B. The Pass Through of the Discharge of Indebtedness Income

Turning to the merits of the Farleys' appeal, we focus first on the statutory language of the Internal Revenue Code. Section 61(a)(12) of the Internal Revenue Code states in relevant part, "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness." 26 U.S.C. § 61(a)(12). This background rule, that discharge of indebtedness income is income, does not apply to insolvent taxpayers. Specifically, § 108(a)(1)(B) of the Internal Revenue Code states that "gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of

indebtedness of the taxpayer if . . . the discharge occurs when the taxpayer is insolvent." 26 U.S.C. § 108(a)(1)(B).

The exclusion of discharge of indebtedness income from gross income provided for in § 108(a)(1)(B) is not without a price. A taxpayer excluding discharge of indebtedness income from gross income must make corresponding reductions in certain tax attributes, attributes that might otherwise yield future tax benefits. Pursuant to § 108(b)(1) of the Internal Revenue Code, "[t]he amount excluded from gross income under [§ 108(a)(1)(b)] shall be applied to reduce tax attributes of the taxpayer as provided in [§ 108(b)(2)]." 26 U.S.C. § 108(b)(1). Discharge of indebtedness income is thus offset against the various "tax attributes" listed in § 108(b)(2) – net operating losses, general business credits, minimum tax credits, capital loss carryovers, basis (to the extent permitted under Section 1017(b) of the Internal Revenue Code), passive activity loss and credit carryovers, and foreign tax credit carryovers. *See* 26 U.S.C. § 108(b)(2)(A)-(G).[3]

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[3] The parties in this case do not dispute that an S corporation can have only two of the tax attributes listed in § 108(b)(2) – the basis of the S corporation's assets and § 1366(d)(1) losses, which are considered net operating losses under § 108(d)(7)(B) and as such are subject to reduction pursuant to § 108(b)(2)(A). *See* 26 U.S.C. § 108(d)(7)(B) ("In the case of an S corporation, for purposes of [§ 108(b)(2)(A)], any loss or deduction which is disallowed for the taxable year of the discharge under § 1366(d)(1) shall be treated as a net operating loss for such taxable year."). All other "tax attributes" listed in § 108(b)(2)(A)-(G) pass through to S corporation shareholders pursuant to § 1366(a)(1).

In challenging the District Court's grant of summary judgment, the Farleys argue that discharge of indebtedness income excluded from gross income under 26 U.S.C. § 108(a) passes through to the shareholders of an S corporation on a pro rata basis pursuant to § 1366 of the Internal Revenue Code. As support for this argument, the Farleys cite § 1366(a)(1)(A) of the Internal Revenue Code, which states that the determination of an S corporation's shareholder's tax liability for the shareholder's tax year during which the S corporation's tax year ends takes into account the shareholder's pro rata share of the S corporation's "items of income (including tax exempt income), loss, deduction, or credit, the separate treatment of which could affect the liability for tax of any shareholder." 26 U.S.C. § 1366(a)(1)(A). The Farleys also cite § 1366(c) of the Internal Revenue Code, which states that "in any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation." 26 U.S.C. § 1366(c).

The Farleys further argue that discharge of indebtedness income, after passing through to the shareholders of the S corporation pursuant to § 1366, increases the basis of the shareholders' stock pursuant to § 1367. Specifically, under § 1367(a)(1)(A), an S corporation's shareholder's basis in the stock of the corporation is increased for any period by, inter alia, items of income described in § 1366(a)(1)(A). *See* 26 U.S.C. § 1367(a)(1)(A). As § 1367(a)(1)(A) states, "[t]he basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: the

items of income described in subparagraph (A) of § 1366(a)(1). . . . " 26 U.S.C. § 1367(a)(1)(A).

As the preceding discussion demonstrates, the key to unraveling this case is understanding how the relevant statutory provisions interact. As discussed above, § 1366, which describes how and when income, losses, deductions and credits pass through to S corporation shareholders, and § 1367, which sets forth the framework for increasing and decreasing the basis of S corporation stock, must be read in conjunction with the § 108.

As mentioned above, § 108(a)(1) provides that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayers if . . . the discharge occurs when the taxpayer is insolvent." 26 U.S.C. § 108(a)(1). It is not disputed that the Farley S Corporations were insolvent at the time of the discharge of indebtedness. And as discussed above, discharge of indebtedness income excluded from gross income pursuant to § 108(b) offsets various tax attributes listed in § 108(b)(2). Pursuant to § 108(b)(4)(A), the reduction in tax attributes mandated by § 108(b)(2) is made after the determination of the tax imposed on the taxpayer (the S corporation shareholder) for the year of discharge. *See* 26 U.S.C. § 108(b)(4)(A) ("The reduction made in [§ 108(b)(2)] shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.") (emphasis added). Furthermore, pursuant to § 108(d)(7)(A), discharge of indebtedness income exclusions (§ 108(a)) and tax attribute reduction principles (§ 108(b)) must be applied at the corporate level. *See* 26 U.S.C. § 108(d)(7)(A) ("In the case of an S

corporation, [§ 108(a) and § 108(b)] shall be applied at the corporate level.").

The ultimate disposition of this case hinges on the interaction of § 108(d)(7)(A) with § 108(b)(4)(A). Section 108(d)(7)(A), which states that the discharge of indebtedness income exclusion and tax attribute reduction principles should be applied at the corporate level, has two primary effects. First, § 108(d)(7)(A) requires the solvency determination in § 108(a)(1)(b) to be made at the corporate level. That is, when determining whether the "taxpayer is insolvent," and thus whether discharge of indebtedness income is excluded from gross income, one must determine whether the S corporation itself is insolvent, not whether a specific individual shareholder is insolvent. Second, and more importantly, § 108(d)(7)(A) requires that the tax attribute reduction principles set forth in § 108(b) be applied at the corporate level. That is, when reducing tax attributes as required by § 108(b), discharge of indebtedness income excluded from gross income pursuant to § 108(a)(1)(A) shall be applied to reduce the tax attributes of the corporation, rather than the individual shareholder.

Section 108(b)(4)(A) states that "[t]he reductions described in [§ 108(b)(2)] shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." 26 U.S.C. § 108(b)(4)(A) (emphasis added). As the Tenth Circuit observed in *Gitlitz*:

> The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures precede the pass-through, the corporation's excluded discharge

> of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. . . . If, on the other hand, attribute reduction takes place after the pass-through, the taxpayers' theory must prevail.

Gitlitz v. Commissioner, 182 F.3d 1143, 1148 (10th Cir. 1999).[4]

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[4] Contrary to our holding today, in *Gitlitz*, the Tenth Circuit held that COD income excluded from gross income under § 108 did not pass through to the S corporation's shareholders and therefore did not increase the basis of their S corporation stock. *See Gitlitz*, 182 F.3d at 1151. The Tenth Circuit concluded that the timing of pass-through under § 1366 ultimately determined the outcome of the appeal. *See id.* at 1148. The court further concluded that attribute reduction under § 108(b) preceded the pass-through of excluded COD income and, as such, the S corporation's COD income was absorbed before it could pass through to the shareholders and increase the basis of their S corporation stock. *See id.* According to the Court, this construction avoided potential windfalls. *See id.* at 1148-49.

The court in *Gitlitz* had difficulty determining the role of § 108(b)(4)(A) in the tax calculation and ultimately concluded that § 108(b)(4)(A) was simply designed to compute certain tax applications (such as establishing ceilings for deductions and credits under § 108(b)(2), charitable contribution limits, alternative minimum tax liability, etc.) before reducing tax attributes. *See id.* at 1150. Thus, the court did not read the statute as mandating attribute reductions in the tax year following the year of the discharge. *See id.* However, the Tenth Circuit conceded that if it read § 108(b)(4) narrowly and in isolation, the taxpayers' argument was plausible, that is, that Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge. *See id.* The court refused to do so, however, finding that it was required to read the Internal Revenue Code as a whole, so as not to " 'defeat the object intended to be accomplished.' " *Id.* (citation omitted). Thus, the court concluded that the taxpayers' interpretation of

The language in § 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of the discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. Discharge of indebtedness income, considered income under § 61(a)(12), is excluded from gross income pursuant to § 108(a)(1)(B) if, as in this case, the S corporation is insolvent. This solvency determination is made at the corporate level rather than the individual shareholder level pursuant to § 108(d)(7)(A). Discharge of indebtedness income excluded from gross income under § 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to § 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholders' S corporation stock pursuant to § 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally, the tax attribute reduction required by § 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by § 108(b)(4)(A).

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§ 108(b)(4)(A) would negate the effect of the tax attribution scheme and result in an unwarranted windfall to the taxpayers. *See id.*

The Tenth Circuit's interpretation of § 108(b)(4)(A) in *Gitlitz* ignores the plain meaning of the statute. Because wefind that the language of § 108(b)(4)(A) is clear and unambiguous, we decline to follow the Tenth Circuit's holding in *Gitlitz* and hold that COD income excluded from gross income under § 108 passes through to the S corporation's shareholders, increasing the basis of their S corporation stock.

We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by § 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under § 1366(d)(1). As such, the Farleys were entitled not only to increase the basis of their S corporation stock but also to take deductions for the Suspended Losses.

C. The Government's Contentions

While we hold that the District Court erred in disallowing the Relevant Refunds, we will address some of the arguments advanced by the Government in their brief and at oral argument. The Government initially argues that the District Court's grant of summary judgment was appropriate because a contrary holding would provide the Farleys with "unwarranted double tax benefits," an unjustified tax "windfall," or a tax benefit not "intended" by the statute. Although one could argue that the outcome mandated by the statutory language was not the outcome intended by Congress, we have nevertheless found that the statutory language is clear and

unambiguous.[5] Moreover, other than *Gitlitz*, the Government cites no case to support its assertion that if the Farleys prevail, they will receive "unwarranted double

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[5] The term "unwarranted" or "unjustified" is used in the sense that the taxpayers have not borne any economic outlay for the tax benefit of their basis increase. Although tax policy generally dictates that a taxpayer is only entitled to an increase in basis for his investment of after-tax dollars, numerous exceptions to that rule exist. *See* James D. Lockhart and James E. Duffy, Tax Court Rules in Nelson That S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 10 J. S Corporation Tax'n 256 (Winter 1999), reprinted in 25 Wm. Mitchell L. Rev. 287, 303 (1999). For example, under §§ 101 and 103 of the Internal Revenue Code, tax-exempt income derived from certain life insurance contracts and state and local bonds purchased by an S corporation is passed through to shareholders under §§ 1366 and 1367 thus producing an increase in the basis of the S corporation's stock without any direct economic outlay by the shareholder. *See* James D. Lockhart and James E. Duffy, Tax Court Rules in Nelson That S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 25 Wm. Mitchell L. Rev. 287, 303-04 (1999). Since Congress has seen fit to allow "unwarranted" tax benefits under §§ 101 and 103, and since the statutory language in § 108 (with respect to COD income excluded from gross income) is identical to that in §§ 101 and 103, § 108 cannot be distinguished from §§ 101 and 103 on the basis of economic outlay considerations. *See id.* at 306. Nonetheless, to the extent that application of the relevant statutes results in a "perceived" unwarranted windfall, principles of judicial restraint dictate that the statute be applied as written unless such application would create an absurd result." *See id.* (citing *Exxon Corp. v. Commissioner*, 102 T.C. 721, 727-28 (1994)). Even the Tenth Circuit in *Gitlitz*, which concluded that Congress did not intend to grant the taxpayers the equivalent of a double deduction and ultimately held for the Government on facts virtually identical to those presented here, acknowledged that the "taxpayer's argument [wa]s not without merit." *Gitlitz*, 182 F.3d at 1148.

tax benefits" or an unjustified tax "windfall." In addition, the Government presents scant evidence that a decision in favor of the taxpayers would provide them with a tax benefit not intended by Congress. With the exception of the legislative history of the Omnibus Budget Reconciliation Act, which we discuss *infra*, the Government's initial argument finds little support in the case law or elsewhere.

The Government next argues that the taxpayers' argument is flawed because "it effectively reads §§ 108(b)(2)(A) and 108(d)(7)(B) – which require excluded discharge of indebtedness income to reduce S corporation net operating losses for the taxable year of discharge – out of the Code." In support of this proposition, the Government cites *Gitlitz* in which the court stated that the "[t]axpayers' interpretation of § 108(b)(4)(A) would negate the effect of the tax attribution scheme and would give taxpayers an unwarranted windfall." *Gitlitz*, 182 F.3d at 1150. The Government's argument is, however, flawed. Nothing in § 108(d)(7)(B) "require[s] excluded discharge of indebtedness income to reduce S corporation net operating losses for the taxable year of discharge;" in fact, nothing in § 108(d)(7)(B) even suggests such a conclusion. Section 108(d)(7)(B) states:

> In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under § 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to

> any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

26 U.S.C. § 108(d)(7)(B).

As we see from this language, § 108(d)(7)(B) does state that losses or deductions disallowed in the taxable year of discharge pursuant to § 1366(d)(1) must be considered net operating losses for the year of taxable discharge pursuant to § 108(b)(2)(D). However, nowhere does § 108(d)(7)(B) indicate that S corporation discharge of indebtedness income should reduce such net operating losses "for the taxable year of discharge." While this conclusion is an integral part of the Government's argument, it finds no support in the language of the statute.

As a corollary to the above argument, the Government suggests that because S corporations do not have most of 17 the tax attributes listed in § 108(b)(2) (for example, general business credits, minimum tax credits, or capital loss carryovers), the Farleys' interpretation of § 108(b)(4)(A) negates the effect of the tax attribute reduction scheme detailed in § 108(a)-(b). This argument misses the mark for two reasons.

First, § 108(a)-(b) is not specific to S corporations; it applies to partnerships and C corporations as well. As such, even if § 108(b)(2) is superfluous in part with respect to S corporations, it does not imply that the entire tax attribute scheme set forth in § 108(a)-(b) is negated by the Farleys' interpretation of § 108(b)(4)(A). Even though some parts of § 108(a)-(b) are inapplicable to S corporations, these parts may be applicable to C corporations or partnerships.

Second, S corporations typically do have at least one of the tax attributes listed in § 108(b)(2), mainly basis in the S corporation's assets. Thus, the tax attribute reduction scheme set forth in § 108(a)-(b) is not negated by the Farleys' interpretation of § 108(b)(4)(A), but rather is implemented by reducing the basis of an S corporation's assets. The Government counters by noting that under § 1017(b)(2), basis cannot be reduced below the debt secured by the assets. While this is true, and while an insolvent S corporation may likely have incurred as much secured debt as possible (thus leaving no basis above the amount of debt secured by its assets to be reduced), it is certainly possible for an S corporation to incur enough unsecured debt to become insolvent, while maintaining basis in its assets above the amount of debt secured by those assets. In such a situation, discharge of indebtedness income would reduce the basis of the S corporation's assets pursuant to §§ 108(b)(2) and 108(b)(4)(A) on the first day of the tax year following the year of the discharge of indebtedness. Thus, to quote *United States v. Nordic Village, Inc.*, it is possible to construe the statute "in such fashion that every word has some operative effect." *United States v. Nordic Village, Inc.*, 503 U.S. 30, 36 (1992); *cf.* Brief for Appellee at 41, *United States v. Farley*, No. 99-3209 (citing *Nordic Village* as support for the proposition that "a statute must, if possible, be construed in such fashion that every word has some operative effect").

The Government next argues that when § 1366(a)(1)(A) is read in conjunction with § 108(d)(7)(A), it is clear that discharge of indebtedness income does not pass through to the shareholders of an S corporation. The Government contends that "section 108 of the Code bars

taxpayers from receiving deductions for their suspended losses." The Government argues (consistent with the Tenth Circuit's holding in Gitlitz) that when discharge of an S corporation's indebtedness is excluded from income due to the S corporation's insolvency, the shareholder's pro rata share of the discharge of indebtedness income does not pass through to the shareholders but rather is either completely absorbed by the S corporation's net operating losses or, if not completely absorbed, is disregarded. Specifically, the Government argues that § 1366(b), which requires that "the character of an item passed through under § 1366(a)(1)(A) is determined as if realized 'directly from the source from which realized by the corporation' . . . cannot be applied to an item of income that is excludable at the corporate level." This argument, however, also misses the mark. It is not disputed that tax attributes are reduced at the corporate level; the question is when the reduction occurs. If the reduction occurs after the pass through of discharge of indebtedness income, as the Farleys argue and as the language of § 108(b)(4)(A) requires, then the shareholders of an S corporation can adjust their basis upward and deduct otherwise undeductible loses.

To bolster its argument, however, the Government refers to § 1366(b)[6] and quotes the Tax Court's opinion in *Nelson v. Commissioner*, in which Judge Beghe stated:

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[6] Section 1366(b) provides that the character of each tax "item" in § 1366(a)(1)(A) is determined as if it were realized directly from the source from which the S corporation realized it or incurred in the same manner as incurred by the S corporation. *See* 26 U.S.C. § 1366(b).

"Section 1366(b) refutes [the taxpayer's] passthrough interpretation of § 108(d)(7)(A). There's no way, actually or fictively, in which the equivalence rule of § 1366(b) could apply to a solvent shareholder of an insolvent S corporation." *Nelson*, 110 T.C. 114, 131-32 (Beghe, J., concurring) (1998). This statement, made without elaboration by Judge Beghe, is simply incorrect. Section 1366(b) can and does apply and does so "fictively" as required by the statute. *See* 26 U.S.C. § 1366(b) ("The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.") (emphasis added).

The Government next argues that the "[t]axpayer's construction of the Code" places § 108(d)(7)(A) in conflict with § 1366(b). According to the Government, "[i]n the case of discharge of indebtedness income realized by an insolvent S corporation with a solvent shareholder," a situation that is fairly common and almost certainly was envisioned by Congress, "section 108(d)(7)(A) would mandate that the income would be excludable from gross income, while § 1366(b) would mandate that the income would be taxable." Once more, however, the Government's argument is flawed. Section 1366(b) deals with the character of income which has been passed through to the shareholder, while § 108(d)(7)(A) deals with the application of the discharge of indebtedness income exclusion requirement and tax attribute reduction scheme detailed in §§ 108(a)-(b). These two statutory provisions address different issues at different levels.

The Government goes on to argue that "[t]he double tax benefit advocated by taxpayers in this case . . . is [ ] fundamentally at odds with the structure of Subchapter S." The Government argues that no other type of income (taxable or tax-exempt) realized by an S corporation results in the double tax benefit argued for by the Farleys. As mentioned earlier, §§ 101 and 103, in conjunction with §§ 1366 and 1367, generate tax-exempt income that results in an apparent "double tax benefit" for S corporation shareholders. *See supra* note 5. Even if the Government's argument were correct, it does not provide us with the freedom to ignore the unambiguous statutory language.

Both the taxpayers and the Government argue extensively about whether, in the case of an insolvent S corporation, discharge of indebtedness (or COD) income is tax-exempt income. It is beyond dispute that discharge of indebtedness income of an insolvent S corporation is "income" under § 1366. The taxpayers argue that discharge of indebtedness income is tax-exempt income while the Government argues that discharge of indebtedness income is not tax-exempt income but rather tax-deferred income. The taxpayers in making their argument rely on the legislative history of the Subchapter S Revision Act of 1982, which states with respect to § 1366:

> The following examples illustrate the operation of the bill's pass-through rules. . . . Tax exempt interest will pass through to the shareholders as such and will increase the shareholders' basis in their subchapter S stock. Subsequent

> distributions will not result in taxation of the tax-exempt income.

S. Rep. No. 97-640, at 16 (1982).[7]

However, this disagreement between the Government and the Farleys as to the nature of discharge of indebtedness income has little relevance. As Judge Beghe correctly noted in his concurrence in *Nelson*:

> No extended exegesis to determine the character of COD [Income] of an insolvent S corporation as "tax-exempt income," or as "deferred income," or as an unrealized "tax nothing" is needed. . . . The only relevant inquiry under § 1366 is not whether COD excluded from gross income of an insolvent S corporation is "tax-exempt income," but whether it's a passthrough item at all.

Nelson v. Commissioner, 110 T.C. 114, 130, 134 (1998) (Beghe, J., concurring); *cf. Gitlitz v. Commissioner*, 182 F.3d 143, 151 n.7 (10th Cir. 1999) ("We assume here that excluded discharge of indebtedness is tax-exempt income.").

The statute is clear – all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to § 1366(a)(1)(A). In the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by § 108(a) increases the shareholder's basis in their S corporation stock after it passes through to the shareholders of the

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[7] It is undisputed that if discharge of indebtedness income is treated like tax-exempt interest, the taxpayers must prevail. *See* S. Rep. No. 97-640, at 16 (1982).

corporation. This allows shareholders to take deductions for S corporation losses previously suspended under § 1366(d)(1).

The Government's argument, that discharge of indebtedness income is not tax-exempt income but rather tax-deferred income, is not without merit. However, beyond citing one Senate Report that suggests Congress intended to defer taxes on discharge of indebtedness income, the Government's argument is not compelling. *See* S. Rep. No. 96-1035, 96th Cong. 2d Sess. 2, 1980-2 C.B. 620, at 625 ("[T]he rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge."). Ultimately, the Government argues that since discharge of indebtedness income is sometimes deferred, it should always be considered tax-deferred income. This argument suffers from one critical weakness – as the Government concedes, discharge of indebtedness income is sometimes tax-exempt.[8] If discharge of indebtedness income is sometimes tax-exempt income and sometimes tax-deferred income, it is hard to see how the Government concludes, without more support for its position, that discharge of indebtedness income is simply tax-deferred income.

The parties in this case also devote a substantial amount of time to analyzing the legislative history of

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[8] Even under the Government's theory, if discharge of indebtedness income for a given taxable year is greater than suspended losses/net operating losses, the amount by which discharge of indebtedness income exceeds suspended losses/net operating losses is disregarded and thus is tax-exempt.

various statutory provisions. Delving into the legislative history is unnecessary because the statutes' language is unambiguous. Furthermore, the available legislative history either conflicts with or does not directly address the question presented in this case. While the legislative history is as a whole unhelpful, we briefly address two pieces of legislative history which do bear on the issue now before us.

The legislative history of the Subchapter S Revision Act of 1982, in providing examples of pass-through, states with respect to § 1366 that:

> Tax exempt interest will pass through to the shareholders as such and will increase the shareholder's basis in their subchapter S stock. Subsequent distributions by a corporation will not result in taxation of tax-exempt income.

S. Rep. No. 97-640, at 16 (1982). The legislative history of the Subchapter S Revision Act goes on to state that, with respect to § 1367, "both taxable and not taxable income and deductible and nondeductible expenses will serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation." *Id.* at 18.[9] Put simply, discharge of indebtedness income, if treated like tax-exempt interest, passes through to the shareholders of an S corporation and increases the shareholder's basis in the stock. And as the Tenth Circuit in *Gitlitz* concluded:

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[9] Unlike § 1366(a)(1)(A) which references tax-exempt income, the legislative history cited above references taxable and non-taxable income, thus encompassing both tax-exempt and tax-deferred income.

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

Gitlitz, 182 F.3d at 1148. As such, the Senate Report quoted above provides persuasive support for the Farleys' argument.

Also relevant is the legislative history of the Omnibus Budget Reconciliation Act of 1993, in which Congress extended the § 108 discharge of indebtedness exclusion to income from the discharge of "qualified real property business indebtedness." 26 U.S.C. § 108(a)(1)(D). The House Report on the Omnibus Budget Reconciliation Act explains in detail the effect of qualified real property business indebtedness on a shareholder's basis in the stock of an S corporation:

> In applying this provision to income from the discharge of indebtedness of an S corporation . . . the exclusion and basis reduction are both made at the S corporation level (§ 108(d)(7)). The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level. As a result of these rules, if an amount is excluded from the income of an S

> corporation under this provision, the income flowing through to the shareholders will be reduced (compared to what the shareholders' income would have been without the exclusion). Where the reduced basis in the corporation's depreciable property later results in additional income (or a smaller loss) to the corporation because of reduced depreciation or additional gain (or smaller loss) on disposition of the property, the additional income (or smaller loss) will flow through to the shareholders at that time, and will then result in a larger increase (or smaller reduction) in the shareholder's basis than if this provision had not previously applied. Thus, the provision simply defers income to the shareholders.

H.R. Rep. No. 103-111, at 624-25 (1993) reprinted in 1993 U.S.C.C.A.N. 378, 855-56.

The language in the legislative history could be interpreted, as the Government suggests, to mean that discharge of indebtedness income does not pass through to shareholders of an S corporation and therefore does not allow shareholders to increase the basis of their S 24 corporation stock. As one commentator has noted, however, "[w]ere this interpretation applied to all discharges of debt (and not just discharges under Section 108(a)(1)(D)), it could be viewed as a change in pre-existing law." Richard M. Lipton, IRS Challenges S Corporation Basis Increase for COD Income, 81 J. Tax'n 340, 344 (Dec. 1994). When the Internal Revenue Service first addressed this issue in TAM 9423003 (Feb. 28, 1994), which was issued many months after the enactment of the 1993 legislation, it made no mention of the legislative history cited above. *See id.* If the Internal Revenue Service

really viewed the language in § 108(a)(1)(D) as a change in pre-existing law, certainly it would have taken that position in TAM 9423003. Its failure to do so is telltale.

Moreover, we find significance in the fact that Congress, in enacting the 1993 legislation, did not make any changes to §§ 1366 and 1367. Thus, a plausible interpretation of the legislative history of § 108(a)(1)(D) is that it "applies solely for purposes of an S corporation's election to exclude COD income on the discharge of qualified real property business indebtedness – by its terms, it does not apply to discharges of other types of debt." Richard M. Lipton, IRS Challenges S Corporation Basis Increase for COD Income, 81 J. Tax'n 340, 344 (Dec. 1994). It seems unlikely, therefore, that Congress, by commenting on the application of one section of the Internal Revenue Code (§ 108), intended to determine how basis adjustments are made under another section (Subchapter S), especially where the language of the legislative history is inconsistent with the plain meaning of the statute.

Together, these two conflicting pieces of legislative history are the only ones that directly address the issue presented in this case. Ultimately, as the Tenth Circuit Court of Appeals observed, the legislative history is "largely unhelpful." *Gitlitz*, 182 F.3d at 1148. Although many other pieces of legislative history are cited by the Government, the Farleys, and commentators writing on this subject, the legislative history as a whole conflicts and provides little insight. And, as discussed earlier, the legislative history is unnecessary and irrelevant to our holding here – the statutory language is clear and unambiguous.

IV. Conclusion

Because we conclude that the District Court ignored the unambiguous language of the controlling statutes in granting the Government's motion for summary judgment, we will reverse the District Court's grant of summary judgment[10] and remand the case to the District Court to enter judgment in favor of the Farleys.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

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[10] We are aware that the result reached today in interpreting the relevant statutory language may not have been the result intended by Congress. However, we are not free to disregard the clear and unambiguous language of the controlling statutes. It is the function of this court to interpret the statutory language as written. If policy considerations suggest that the Code should be amended, Congress can do so. We may not.

Supreme Court, U.S.
FILED
MAR 31 2000
CLERK

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No. 99-1295

In the Supreme Court of the United States

DAVID A. AND LOUISE A. GITLITZ, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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23PP

QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation. During 1991, that corporation obtained a discharge of certain indebtedness. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(B). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioners as the shareholders of the Subchapter S corporation, thereby increasing their basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing them to deduct losses they previously were unable to deduct because they had exhausted their basis by prior deductions.

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In the Supreme Court of the United States

No. 99-1295

DAVID A. AND LOUISE A. GITLITZ, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 182 F.3d 1143. The initial opinion of the Tax Court (Pet. App. 25-31) is unofficially reported at 73 T.C.M. (CCH) 3167. The opinion of the Tax Court on reconsideration (Pet. App. 21-24), which withdrew and replaced the initial opinion, is unofficially reported at 75 T.C.M. (CCH) 1840.

JURISDICTION

The judgment of the court of appeals was entered on July 6, 1999. A petition for rehearing was denied on November 3, 1999 (Pet. App. 32-33). The petition for a writ of certiorari was filed on February 1, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. During the 1991 taxable year, petitioners David A. Gitlitz and Philip D. Winn each owned a 50% interest in P.D.W. & A., Inc. (PDW&A), a Colorado corporation that elected to be taxed for that year under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 2-3. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

The Subchapter S corporation was a partner in a partnership that was discharged from $4,154,891 in debt during 1991. Pet. App. 3. The corporation's share of this income was $2,021,296, and this amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) except that, at the time of the discharge, the corporation was insolvent. Because the corporation was insolvent, this amount was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).

b. Although Section 108 of the Code thus specifies that discharge of indebtness is *not* an item of income for an insolvent corporation, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax

treatment of shareholders of a subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioners had previously deducted losses representing their entire basis in the corporate stock. Pet. App. 3-4. At the time the indebtedness of the Subchapter S corporation was discharged in 1991, petitioners would thus be allowed further deductions from continuing corporate losses only if their basis were somehow increased.[1]

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[1] Petitioners had exhausted their basis in the corporate stock by deductions taken in prior years. See Pet. App. 3; 26 U.S.C. 1367(a)(2). The losses of the corporation incurred *prior* to 1991, which petitioners had been unable to deduct because they had exhausted their basis, are described as "suspended" losses and are carried into future years; they may be deducted in future years

Petitioners assert that the additional basis that they need in order to take further deductions from prior corporate losses can be found in the discharge of indebtedness "income" of the corporation in 1991. They assert that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) which increases their basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this item is "*not*" an item of income. They thus claimed additional deductions in an amount equivalent to their allocable share of the discharged debt of $2,021,296. Pet. App. 3.

Upon audit, the Commissioner determined that petitioners were not entitled to increase their stock basis by their reported *pro rata* shares of the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the deductions claimed by petitioners and asserted a deficiency of $251,192 against petitioner Gitlitz and of $242,555 against petitioner Winn. Pet. App. 64-66, 81-83.

2. Petitioners filed separate petitions in Tax Court which were consolidated for disposition. On cross-motions for summary judgment, the Tax Court initially ruled in favor of petitioners. Pet. App. 25-31. The court stated (*id.* at 29-30) that, because income from the discharge of indebtedness is an item of income in the general definition of gross income (26 U.S.C. 61(a)(12)), it qualifies as an "item[] of income" for which an upward basis adjustment is appropriate under 26 U.S.C.

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only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

1366(a)(1)(A) even though, due to the insolvency of the debtor, it is excluded from income under Section 108(a).

The Commissioner moved for reconsideration. While that motion was pending, the entire Tax Court held in a reviewed decision that a discharged debt that is excluded from a Subchapter S corporation's gross income because of its insolvency does *not* constitute an item of "income" that would increase the shareholder's basis in the corporate stock (and thereby allow deductions of losses after that basis has been exhausted by prior deductions). *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999). Relying on its decision in *Nelson*, the Tax Court then granted the motion for reconsideration in this case and entered judgment in favor of the Commissioner. Pet. App. 21-24.

3. The Tenth Circuit affirmed. Pet. App. 1-20.[2] The court of appeals emphasized that petitioners' proposed interpretation of the Code would accomplish an inappropriate double tax benefit for taxpayers: it would permit the insolvent Subchapter S corporation to avoid tax on an item that is "not" treated as an item of income under Section 108(a); at the same time, it would allow the shareholders to reduce their gross income from *other* sources by treating this same item as if it *were* an item of "income," thereby increasing their basis in the corporate stock and permitting deductions otherwise barred by the prior exhaustion of their basis (Pet. App. 10). The court noted that this Court has emphasized

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[2] The taxpayer in *Nelson* v. *Commissioner* also appealed the Tax Court's decision in that case to the Tenth Circuit. The court of appeals affirmed the Tax Court's decision on the authority of its opinion in this case. *Nelson* v. *Commissioner*, 182 F.3d 1152 (1999). The taxpayer in *Nelson* did not file a petition for a writ of certiorari.

that the Internal Revenue Code "should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction absent a clear declaration of intent by Congress." *Ibid.* (quoting *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969)). The court concluded that "only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here" (Pet. App. 10) and that petitioners did not meet that burden.

The court noted that a discharge of indebtedness does "not" constitute an item of income under Section 108(a) if "the debt is * * * discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent" (Pet. App. 9) and that this characterization of the item is necessarily made and "applied at the *corporate* level" (*id.* at 11). The court explained that petitioners' effort nonetheless to treat it as an "item[ ] of income" under Section 1366 ignores "the 'price' Congress imposed upon entities whose discharge[] [of indebtedness] income is excluded under § 108." Pet. App. 13. That "price" is set forth in the provisions of Section 108(b), which requires the insolvent corporation to reduce various "tax attributes" (such as carried over credits or losses) "that could otherwise yield future tax benefits." *Id.* at 9. In deciding in Section 108 to "not" treat a discharge of debts owed by an insolvent as "income," Congress did not mean to provide additional tax benefits to the corporate shareholders in the manner proposed by petitioners; instead, Congress determined in Section 108(b) to reduce the preexisting tax carryforwards available to the corporation that might yield "future tax benefits." Pet. App. 9. The court concluded that petitioners' interpretation of these statutes "would negate the effect of the tax attribution scheme and

would give [petitioners] an unwarranted windfall." *Id.* at 16.

DISCUSSION

In Section 108 of the Internal Revenue Code, Congress specified that the discharge of a debt owed by an insolvent corporation does "not" constitute income to that corporation. The Tenth Circuit correctly held in this case that shareholders of an insolvent Subchapter S corporation may not treat the amount that is thus expressly "not" income as if it *were* an "item of income" which, under Section 1366, would increase the shareholders' basis in the corporate stock and allow the deduction of otherwise nondeductible losses. The decision in this case is supported by the recent decision of the Seventh Circuit in *Witzel* v. *Commissioner*, 200 F.3d 496 (2000). But see note 7, *infra*. Both of these decisions, however, directly conflict with the decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198 (2000) (Pet. App. 92-124), which expressly declined to follow the decision in this case. See *id.* at 108-109 n.4.[3]

This direct and acknowledged conflict among the courts of appeals warrants review by this Court. The issue that has divided these courts has substantial administrative importance and is frequently the subject of audits and litigation. In addition to the three circuits that have already issued conflicting decisions, the same question presented in this case is already pending in three other circuits. See *Friedman* v. *Commissioner*, 75 T.C.M. (CCH) 2383 (1998), on appeal, No. 98-2378 (6th Cir.); *Gaudiano* v. *Commissioner*, 76 T.C.M.

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[3] We intend to file a petition for a writ of certiorari in *United States* v. *Farley*, *supra*, suggesting that that case be held pending the Court's disposition of this case.

(CCH) 858 (1998), on appeal, No. 99-1294 (6th Cir.); *Pugh* v. *Commissioner*, 77 T.C.M. (CCH) 1367 (1999), on appeal, No. 99-12646 (11th Cir.); *Hogue* v. *United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,149 (D. Ore. Jan. 3, 2000), on appeal, No. 00-35208 (9th Cir.); *Eberle* v. *Commissioner*, 78 T.C.M. (CCH) 366 (1999), on appeal, No. 00-70159 (9th Cir.). In addition, more than 30 other cases raising this same issue are currently pending in Tax Court or in refund suits in federal district courts. These cases are appealable to the various circuits located throughout the Nation in which these taxpayers reside. See 26 U.S.C. 7482(b)(1)(A).

Unless this clear and acknowledged conflict among the circuits is resolved by this Court, the taxation of shareholders of Subchapter S corporations will vary due to geographical happenstance, depending solely upon the circuit in which the taxpayer happens to reside. Review of this recurring issue by this Court is needed to avoid continuing uncertainty and inconsistent application of the revenue laws, and we therefore do not oppose the granting of the petition for a writ of certiorari in this case.

1. Under Section 108(a)(1)(B) of the Code, the discharge of a debt owed by an insolvent taxpayer is "not" included in gross income to the extent of the insolvency. 26 U.S.C. 108(a)(1)(B), (d)(3).[4] As the result, that item is not treated as an "item of income" for any purpose, including for the basis adjustment purposes of Section 1366. Instead of treating and taxing this as an "item of income," the Code directs the taxpayer to use this excluded item to reduce (or eliminate) certain favorable

[4] Section 108 provides the same treatment for the discharge of a debt in a bankruptcy case and for the discharge of "qualified farm indebtedness." 26 U.S.C. 108(a)(1)(A), (C).

"tax attributes" that the taxpayer could otherwise employ to reduce its taxable income in future years. 26 U.S.C. 108(b)(1)-(2).[5] Any debt discharge amount remaining after application against these favorable tax attributes is then to be "disregarded, i.e., *does not result in income or have other tax consequences.*"

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[5] Under Section 108(b)(1), "[t]he amount excluded from gross income under * * * subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." 26 U.S.C. 108(b)(1). Section 108(d)(7)(A) prescribes that, in the case of discharge of indebtedness by an S corporation, Sections 108(a) and (b) "shall be applied at the corporate level." 26 U.S.C. 108(d)(7)(A).

Under Section 108(b)(2), the amount excluded under Section 108(a)(1) is generally applied to reduce the following tax attributes in the following order: (i) any net operating loss for the taxable year of the discharge and any net operating loss carryover to the taxable year of the discharge, (ii) a general business credit, (iii) capital loss carryovers, (iv) the basis of property of the taxpayer and (v) foreign credit tax carryovers. 26 U.S.C. 108(b)(2)(A)-(G). The reductions are dollar for dollar for net operating losses, capital loss carryovers and basis reduction, and 33.33 cents for each dollar excluded under Section 108(a) for the general business credit and foreign tax credit carryovers. 26 U.S.C. 108(b)(3)(A)-(B). Section 108(d)(7)(B) defines an S corporation "net operating loss" for purposes of Section 108(b)(2)(A) as "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) * * *." 26 U.S.C. 108(d)(7)(B).

Under Section 108(b)(5), "[t]he taxpayer may elect to apply any portion of the reduction referred to in [Section 108(b)(1)] to the reduction under section 1017 of the basis of the depreciable property of the taxpayer." Section 1017(a) provides that if a portion of the amount excluded under Section 108(a) is applied to reduce the taxpayer's basis in depreciable property, "such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." 26 U.S.C. 1017(a)(2).

S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980) (emphasis added).

By thus using the amount of debt discharge excluded from treatment as "income" by the taxpayer's insolvency to reduce certain favorable tax attributes of the corporation, Congress sought to employ Section 108 as a tax-deferral, rather than tax-forgiveness, mechanism: the taxpayer avoids immediate payment of tax from the debt discharge, but pays increased taxes in future years as a result of the discharge. See S. Rep. No. 1035, *supra*, at 10 ("the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge"). In *United States* v. *Centennial Savings Bank*, 499 U.S. 573, 580 (1991), this Court similarly noted that the effect of the exclusion for the discharge of qualified business indebtedness under former Section 108(a)(1)(C) "is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property."[6]

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[6] In *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), this Court held that a taxpayer realizes taxable income from the discharge of indebtedness. Other courts concluded, however, that the holding in *Kirby Lumber* did not apply to a taxpayer that was insolvent at the time its debts were discharged and remained insolvent after the discharge occurred. See, *e.g.*, *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934); *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. 798, 801 (1949) (collecting cases). Under these decisions, the discharge of indebtedness did not represent taxable income for the insolvent taxpayer and had no effect on any of the taxpayer's tax attributes. 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 6.4.6, at 6-58 n.97 (2d ed. 1989). A

2. a. Section 1366(d)(1) limits the aggregate amount of an S corporation's losses taken into account by a shareholder (under Section 1366(a)) to the sum of the shareholder's adjusted basis in the stock of the corporation plus his adjusted basis in any corporate debt owed to the shareholder. Losses that may not be deducted by the shareholder for this reason are described as "suspended" losses; they may be carried forward

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variety of statutory provisions have been enacted, however, to require offsetting adjustments of favorable tax attributes to reflect an insolvent's discharge of indebtedness.

The current statutory scheme was first enacted as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed. 1999). The original provisions of Section 108 enacted in 1980, however, did not refer to S corporations. In the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 3(e), 96 Stat. 1689, however, Congress amended Section 108(d)(6) to provide that, in the case of S corporations, the exclusion from gross income and the reduction in tax attributes were to occur at the shareholder, rather than corporate, level. Congress reversed itself on that issue, however, in 1984 by enacting Section 108(d)(7), which provides that, in the case of S corporations, the exclusion and the attribute reduction are to take place at the corporate level, and that any (shareholder) loss disallowed for the year of the discharge under Section 1366(d)(1) is to be treated as a net operating loss for that year. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(b), 98 Stat. 966. The purpose of the 1984 amendment is "to treat all shareholders in the same manner" (H.R. Rep. No. 432, 98th Cong., 1st Sess. 334 (1984)), and Congress envisioned that "the exclusion of income arising from discharge of indebtedness and the corresponding reductions in attributes (including losses which are not allowed by reason of any shareholder's basis limitation) are made at the corporate level" (*ibid.*). Because the 1984 amendment "t[ook] effect as if included in the Subchapter S Revision Act of 1982" (§ 721(y)(1), 98 Stat. 972), the 1982 provisions that would have made the exclusion and attribute reduction operative at the shareholder level were never effective.

indefinitely and deducted in any subsequent year in which the shareholder increases his basis in the corporation's stock or debt. 26 U.S.C. 1366(d)(2).

A shareholder's basis in stock of the corporation is increased by his pro rata share of the "items of income (including tax-exempt income)" of the corporation. 26 U.S.C. 1366(a)(1)(A); see 26 U.S.C. 1367(a)(1)(A). Petitioners claim that the debt discharge, which is "not" income under Section 108(a), is nonetheless an "item of income" of the corporation which increases his basis and allows him to take deductions for losses "suspended" in a prior year because he had previously exhausted his basis by taking other loss deductions.

The court of appeals correctly rejected that claim, not only because it conflicts with the plain language of these provisions but also because it would inappropriately provide petitioners with the "windfall" of a double tax benefit in a context where Congress plainly sought to limit the benefit, not double it. Pet. App. 10.

Petitioners seek to characterize an item as "income" when Congress has instead specified that it is "not" income. Moreover, petitioners do so in an effort to double the benefit of the exclusion of this item from income, for they would use it to increase their ability to take additional, unrelated deductions. But Congress instead carefully specified in Section 108(b) that the benefit of the characterization of this item as "not" income is to be diminished, rather than amplified, by requiring the corporation to make compensating reductions in its favorable tax attributes. See pages 8-9, *supra*. Petitioners' contentions thus conflict with both the text and the obvious spirit of these provisions.

b. In ruling in the taxpayer's favor on this issue in *United States* v. *Farley*, *supra*, the Third Circuit did not dispute that the taxpayer's position would result in

"an apparent 'double tax benefit' for S corporation shareholders." Pet. App. 117. That court also acknowledged that there was strong evidence that the position argued by the taxpayer "may not have been the result intended by Congress." *Id.* at 124 n.10. That court nonetheless concluded that "the clear and unambiguous language" of Section 1366 required it to rule in the taxpayer's favor because, under that provision, "all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation" and thereby "increases the shareholders' basis in their S corporation stock" (Pet. App. 118, 124).

In so holding, however, the Third Circuit failed to take into account (i) that the plain language of Section 108(a) states that the discharge of indebtedness of an insolvent corporation is "not" income (26 U.S.C. 108(a)(1)(B)); (ii) that Section 108(b) requires that item to be applied to reduce the favorable tax attributes of the corporation (26 U.S.C. 108(b)); and (iii) that any remaining balance of that item is then to be "disregarded" and is not to be treated as "result[ing] in income or hav[ing] other tax consequences." S. Rep. No. 1035, *supra*, at 2.[7]

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[7] Section 108(d)(7)(A) provides that, in cases involving insolvent Subchapter S corporations, the amount excluded from the *corporation's* gross income reduces the *corporation's* tax attributes *at the corporate level.* Those attributes include the corporation's net operating loss for the taxable year of the discharge. 26 U.S.C. 108(b)(2)(A). Section 108(d)(7)(B) provides that an insolvent S corporation's net operating loss for the taxable year of the discharge includes its shareholders' suspended losses for that year under Section 1366(d)(1). Under these provisions, the amount excluded from the corporation's gross income under Section 108 remains at the corporate level in order to be available to reduce or eliminate the shareholders' suspended losses; it does not pass

c. The Third Circuit also erred (Pet. App. 111 n.5, 117) in equating the amount excluded under Section 108 with "tax-exempt income," which is encompassed within the items that may pass through to a shareholder and increase the basis of his stock under 26 U.S.C. 1366(a)(1). Although "[t]here is no definition of 'tax exempt' for purposes of section 1366," the term inherently signifies an item that is "exempt on a permanent basis." *Nelson* v. *Commissioner*, 110 T.C. at 125. Thus, items of "tax exempt income" include items such as state and local bond interest and life insurance proceeds, which not only are "not" income in the year received (26 U.S.C. 101, 103) but which are *not* accompanied with the offsetting reductions in tax attributes that make debt discharge income "subject to taxation in the future." 110 T.C. at 125. As this Court explained in *Centennial Savings Bank*, because of the offsetting adjustments of tax attributes required for debt discharge items under Section 108, the result of the

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through to the shareholders to enable them to deduct those losses. *Witzel*, 200 F.3d at 497.

In *Witzel*, the Seventh Circuit agreed with the Tenth Circuit in this case that the amount excluded under Section 108 remains at the corporate level and eliminates suspended shareholder losses for the taxable year of the discharge at that level. 200 F.3d at 497; see note 5, supra. The Seventh Circuit went on, however, in dicta, to state that the amount excluded from the corporation's gross income increased the shareholder's stock basis after eliminating his extant suspended losses. 200 F.3d at 497-498. That conclusion is incorrect. As the language of these provisions indicates, and as the legislative history expressly states, any amount remaining after application against the suspended losses "is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, *supra*, at 2.

statute "is not genuinely to exempt such income from taxation * * * ." 499 U.S. at 580.[8]

When permanently tax exempt items such as state and local bond interest (26 U.S.C. 103) and life insurance proceeds (26 U.S.C. 101) are received by a Subchapter S corporation and passed through to its shareholders under Section 1366(a)(1)(A) as "items of income (including tax-exempt income)," the shareholders receive an *upward* basis adjustment (under Section 1367(a)(1)(A)) that is offset by a corresponding *downward* basis adjustment (under Section 1367(a)(2)(A)) when such income is distributed to the shareholder. 26 U.S.C. 1367(a)(2)(A). As the Tenth Circuit stated in this case (Pet. App. 8-9), the temporary basis increase of such "tax-exempt" items is necessary to *preserve* the tax-exempt character of the income at the shareholder level. In the absence of that basis increase, the

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[8] On December 21, 1999, the Treasury Department promulgated Treas. Reg. § 1.1366-1(a)(2)(viii), which specifies that income excluded under Section 108 is *not* tax-exempt income for purposes of Subchapter S, including the basis adjustment rules of Sections 1366 and 1367. 64 Fed. Reg. 71,643 (1999). The regulation is effective for taxable years beginning on or after August 18, 1998. Treas. Reg. § 1.1366-5.

This new regulation will not resolve the conflict that has developed among the courts of appeals. In ruling against the Commissioner's position in *Farley*, although the Third Circuit suggested (incorrectly) that its position was supported by the reference to "tax-exempt income" in Section 1366(a)(1)(A), the court ultimately concluded that "the nature of discharge of indebtedness income has little relevance" to this case for "[t]he statute is clear—all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to § 1366(a)(1)(A)." Pet. App. 118. The court concluded that discharge of indebtedness is an "item[] of income" for purposes of Section 1366(a)(1) regardless whether it is viewed as a tax-exempt or tax-deferred item. Pet. App. 118.

shareholder would be subject to tax upon the distribution of the "tax-exempt" items under Section 1368(b)(2) of the Code, which specifies that any distribution that exceeds a shareholder's adjusted basis in stock is treated as gain from the sale or exchange of property. 26 U.S.C. 1368(b)(2). By contrast, when debt is discharged, there is no distribution in cash or in kind to the debtor Subchapter S corporation, let alone the shareholder. An upward basis adjustment in this context would simply defeat the plain mandate of Congress that the discharge of indebtedness by an insolvent corporation is "not" to be treated as "income" under the Code. 26 U.S.C. 108(a)(1)(B).

d. Petitioners err in claiming that the "plain language" of Section 108(b)(4)(A) of the Code supports their position in this case (Pet. 13-24). Although the Tenth Circuit discussed that provision at some length in its opinion (Pet. App. 14-16), that statute has no bearing on the proper disposition of this case.

Section 108(b)(4)(A) provides a rule with respect to the timing of the attribute reductions mandated by Section 108(b)(1)-(2). The statute provides that those reductions "shall be made after the determination of the tax imposed * * * for the taxable year of the discharge." 26 U.S.C. 108(b)(4)(A). In practice, this means that the amount excluded under Section 108 is not taken into account by the insolvent taxpayer, and results in no reduction of its attributes, until after the tax for the year of the discharge is computed.[9]

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[9] If the taxpayer elects under Section 108(b)(5) first to reduce its basis in depreciable property in lieu of reducing the attributes in the order prescribed by Section 108(b)(2) (see note 5, *supra*), the basis reduction takes effect under Section 1017 on the first day of the taxable year following the year of the discharge. The timing of the basis reduction in the event of this election was chosen "[i]n

The requirement that the reduction in tax attributes under Section 108(b) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge" (26 U.S.C. 108(b)(4)(A)) applies at the corporate level, not to petitioners as shareholders of the corporation. 26 U.S.C. 108(d)(7)(A). By the express terms of the statute, nothing in Section 108(b) addresses the question whether petitioners may take an amount that is "not" income under Section 108(a) and treat it as an "item[] of income" for the entirely different purposes of Section 1366. Certainly, nothing in Section 108(b)(4)(A) can plausibly be said to be intended to place any taxpayer in a *better* position than he would have been in had the discharge of indebtedness never occurred. As the Tenth Circuit observed in this case, "[t]o embrace [petitioners'] position is to effectively eliminate the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108" (Pet. App. 13).

3. Petitioners' contention that they "seek equal treatment with other insolvent taxpayers" (Pet. 24) is without merit. The court of appeals properly noted that petitioners are in fact seeking a "windfall"; they are seeking to transmute Section 108 into a double tax benefit that would not be available to any taxpayer *except* a shareholder of an insolvent subchapter S corporation (Pet. App. 10).

Petitioners also err in claiming (Pet. 25) that the "Tenth Circuit has unfairly denied any benefit flowing from the § 108(a) exclusion; it might as well have been taxable income." Petitioners have benefitted from Sec-

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order to avoid interaction between basis reduction and reduction of other attributes * * * ." H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980); S. Rep. No. 1035, *supra*, at 14.

tion 108 because they did not pay any tax, and recognized no "income," on the occasion of discharge of indebtedness of the insolvent subchapter S corporation. The decision in this case merely denies petitioners the *double* tax benefit that they erroneously seek.[10]

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted.

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[10] Petitioners erroneously assert (Pet. 7) that the decision in this case conflicts with the decision in *CSI Hydrostatic Testers* v. *Commissioner*, 103 T.C. 398 (1994), aff'd per curiam, 62 F.3d 136 (5th Cir. 1995). As the Tenth Circuit correctly explained (Pet. App. 19-20), the decision in *CSI* did not involve Subchapter S corporations and has no relevance to this case. Instead, that case concerned whether the amount excluded under Section 108 is includable in a Subchapter C corporation's subsidiary's earnings and profits for purposes of the consolidated return regulations rules concerning investment basis adjustment under Section 1502. That case involves entirely different statutory provisions and furnishes no support for the proposition advocated by petitioners in this case.

(3)

Supreme Court, U.S.
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No. 99-1295

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

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I. ADDITIONAL REASONS FOR GRANTING THE WRIT

The Taxpayers and the Government agree that the number of cases pending both in the courts and before the IRS makes resolution of the issue presented in this case a matter of considerable national importance. The issue may also affect a vast number of taxpayers. In 1999, almost 2.7 million S corporation returns were filed.[1] While only a fraction of these S corporations receive cancellation of debt income when they are insolvent, the issue effects thousands of S corporations' shareholders.

II. REPLY TO NEW ARGUMENT IN THE GOVERNMENT'S RESPONSE.

Although the Government acquiesced in Taxpayers' Petition, it makes an argument that was not presented below. Taxpayers file this Reply in order to address this new argument.

A. The Government's Contention That Excluded COD Income Is Not An "Item Of Income" Is Incorrect.

Rather than defending the Tenth Circuit's opinion, the Government makes an argument that was not presented to the Court of Appeals, taking the position that cancellation of debt ("COD") income excluded from tax under 26 U.S.C. § 108(a)(1)(B)[2] does not constitute an

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[1] Zaffino, Frank "Projections of Returns to Be Filed in Calendar Years 2000-2006" This article was posted on March 9, 2000 at the IRS web site as 06RSOIPR.exe at *http://www.irs.gov/tax_stats/soi/other_pr.html.*

[2] All statutory citations, unless otherwise specified, refer to Title 26. Cites to Regulations or Treasury Regulations likewise refer to 26 C.F.R. References to the "Code" refer to the Internal Revenue Code of 1986, Title 26.

"item of income" for purposes of the S corporation shareholder basis rules of §§ 1366 and 1367.

The operative language of § 108(a)(1)(B), like every other exclusion from gross income in the Code (§§ 101-138), utilizes the phrase "gross income shall not include. . . . " Thus, an insolvent taxpayer's COD income is removed from taxable income in the same way as municipal bond interest (§ 103) and life insurance proceeds (§ 101).[3] Section 1366, however, is not limited in its operation to items of income that are included in gross income; section 1366(a)(1)(A) requires that S corporation shareholders take into account their pro rata share of, "items of income ***(including tax-exempt income)***, loss, deduction, or credit the separate treatment of which ***could affect*** the liability for tax of any shareholder." (Emphasis supplied). Thus, the statute specifically includes "tax exempt income," as well as all other income that "could affect" shareholder tax liability, in the basis calculation process. It is then necessary to ask whether COD income of an S corporation is either a species or "tax-exempt" income, or whether it "could affect" the tax liability of any shareholder. The answer to both queries is yes.

1. Excluded COD Income Is "Tax-Exempt" Income.

Citing the Tax Court's opinion in *Nelson v. Commissioner*, 110 T.C. 114, 125 (1998), the Government argues that COD income is not "tax-exempt," but rather "tax-deferred," because it is not "exempt on a permanent basis." Brief for the Respondent, p.14. The Government's rationale is that the correlative attribute reduction

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[3] The Government concedes that income excluded under these two sections of the Code are "items of income" for purposes of the basis adjustments required by §§ 1366 and 1367. Brief for the Respondent, p.15.

scheme set out in § 108(b) makes this statute better characterized as achieving deferral, rather than true exemption from income.[4]

The "tax-deferred" category does not withstand close scrutiny for several reasons. First, and foremost, this category is not supported by any statutory language. Similarly, there is no statutory basis for the Tax Court's "permanence" requirement.

Second, while COD income ***might*** be indirectly linked to a correlative increase in taxable income of a later year as a result of attribute reduction, this fact provides no basis for treating COD income as anything other than "tax-exempt" in the current year. A COD income item is realized in the current year, and that item (*qua* item) is ***never*** realized in any future year. As a result of the exclusion of COD, an attribute, such as basis in a depreciable asset, may be reduced. *See* § 108(b)(2)(E). That reduction may, in turn, cause an increase to future

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[4] In support of the "tax-deferred" argument, the Government cites *United States v. Centennial Savings Bank*, 499 U.S. 573 (1991), in which this Court, in dictum unimportant to any holding in the case, characterized the operation of the "qualified business indebtedness" exclusion of Former § 108(a)(1)(C) as "deferring" tax on income. The "qualified business indebtedness" provision allowed an exclusion, even when the taxpayer was not insolvent or in bankruptcy, if the taxpayer affirmatively "***elects*** to reduce the basis of his depreciable property by an amount equal to the income excluded." 499 U.S. at 580. To be eligible for the "qualified business indebtedness" exclusion, it was necessary that there be complete symmetry between the amount excluded and the correlative consequence. As explained below, under the insolvency exemption, there is no direct tie between exclusion and the amount of attribute reduction in many cases. To claim that a brief characterization (in dicta) of the "qualified business indebtedness" exclusion is controlling for the insolvency exemption, and, moreover, establishes a new class of income ("tax-deferred") that is not referred to anywhere in the Internal Revenue Code, is specious.

year's income subject to tax by reducing depreciation deductions. But it does not cause the item of income excluded in the current year – the COD income – to be taxed in any future year.

Third, the Government's contention, that income exempt under § 108(a)(1)(B) is not permanently exempt because of attribute reduction, ignores the fact that many taxpayers either (1) have no tax attributes to reduce, (2) have COD income in excess of their tax attributes, or (3) have attributes to reduce, but the reduction never results in income recognition. *See Farley v. United States*, 202 F.3d 198, 210 (3d Cir. 2000) (government concedes COD income is sometimes tax exempt). In these instances, the § 108 exclusion will never result in any offsetting increase in tax on future years' income. Such amounts of income will ***never*** be included in taxable income and therefore, even under the *Nelson* court's "permanence" standard, are "tax-exempt."

Fourth, the Treasury Regulations promulgated in 1992 (following the year at issue in this case), and effective until revised during the course of this litigation, provided:

> [A basis] adjustment for a nontaxable item is determined for the taxable year in which the item would have been includable or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Treas.Reg. § 1.1367-1(d)(2) (withdrawn 1999). Under this regulation, if an item of income were "includable" in the current year's income under the corporation's method of accounting, but not subject to federal income taxation ***during that year***, it is a "nontaxable item," and the shareholder is required to increase basis by that amount. COD income was realized and would have been includable in gross income in the year of receipt under the corporation's method of accounting had the COD income been subject to tax. The COD income item (*qua* item) will never be taken into account in any future year.

In addition, while the Government seeks to differentiate income excluded under § 108 from other exclusions under Part III of Subtitle A of the Code (Brief for the Respondent, p.15), prior usage of the term "exempt" in the Internal Revenue Code and in Treasury Regulations belies this distinction.

In this respect, § 139 uses the term "exemption" as a generic description of the exclusions in Part III (§§ 101-139). Section 139 is a cross-reference statute whose operative language provides that "for ***exemption*** of" certain items from income, a designated section of another Title should be consulted.[5] Congress thus considered the statutes found in Part III to be, as a group, "exemptions" from tax, and, indeed, used the term "exemption" as a synonym for "exclusion."

In the regulations governing the allocation and apportionment of deductions to income earned domestically and from foreign sources, the Treasury has construed the phrase "exempt income" broadly to include all income which is "exempt, excluded or eliminated" for federal income tax purposes. Temp.Reg. § 1.861-8T(d)(2)(ii)(A). Treasury recognized that the ordinary, everyday meaning of the word "exempt" is "not subject to tax" and is synonymous with the term "excluded."

Even more compelling, the Consolidated Return Regulation governing parent basis in subsidiaries (which is similar to the rules for shareholder basis in S corporations) treats COD income as "tax exempt," rather than "tax-deferred." The operative provisions of the regulation treat substituted basis transactions (where recognition is deferred until the asset is sold at a later date), e.g., §§ 118, 332, 351 and 1031, as not "tax-exempt" because required basis adjustments prevent the non-recognition from being permanent. Treas.Reg. § 1.1502-32(b)(3)(ii)(A). However, COD income is explicitly characterized by the regulations

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[5] During the year at issue (1991), the identical cross-reference statute was found at § 136.

as a species of "tax-exempt income," to the extent that it is applied to reduce attributes. Treas.Reg. § 1.1502-32(b)(3)(ii)(C)(1). This is contrary to the position of the Government in this case, where the Government strenuously argues that the linked attribute reduction prevents the exclusion for COD income from being truly "tax-exempt."

Given this prior substantial characterization of all excluded income, including COD income, as "tax-exempt," the Government's attempt to manufacture a difference between "exclusion" and "exemption" linked to § 108 potential reduction of attributes must be rejected.

Finally, the IRS issued a technical advice memorandum indicating that when a partnership receives COD income, a partner's pro rata share of that income increases that partner's basis, irrespective of whether that income is taxable or tax-exempt to the partner and irrespective of the fact that attributes may be reduced because of the COD income inclusion. TAM 9739002.[6] The TAM quoted extensively from the legislative history of § 108 and concluded that income excluded from tax under § 108(a) *does* increase basis under § 705 (the partnership analogue of § 1367), even though attributes may be reduced.

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[6] While this ruling is not official precedent under § 6110(j)(3), private letter rulings may be cited for the purpose of providing evidence of the Commissioner's interpretation (*Cantebury v. Commissioner*, 99 T.C. 223, 247 (1992) (*quoting Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962))), insight into the Commissioner's understanding of complex tax issues (*Capitol Fed. S & L Assoc. v. Commissioner*, 96 T.C. 204, 223 (1991)), or evidence of confusion in the Commissioner's interpretation or a change in position. (*Spencer v. Commissioner*, 43 F.3d 226, 234 (6th Cir. 1995)).

2. Excluded COD Income "Could Affect" Shareholder Tax Liability.

The statutory test for whether an item of income is taken into account for purposes of adjusting shareholder's stock basis is whether it "could affect the liability for tax of any shareholder." In the case of an item that is recognized at the corporate level, a pro rata share of the item is included in the shareholder's gross income, and directly effects the tax liability of the shareholder. However, even with respect to items of income realized by the corporation but not recognized, there is still a potential impact upon an individual shareholder's tax liability. With respect to "tax-exempt income," e.g., state and local bond interest under § 103, the separate treatment of the exempt item does not increase gross income. Because income treated as "tax-exempt" at the corporate level will never be treated otherwise at the shareholder level, the meaning of the phrase "could affect the liability for tax of any shareholder" necessarily relates to an indirect or collateral consequence of "tax-exempt income."

When Congress enacted §§ 1366 and 1367, it understood that tax-exempt income realized by the S corporation would be passed through to the shareholders (retaining its exempt character) and increase the shareholders' basis in their stock: "Tax-exempt interest will pass through to the shareholders as such and will increase the shareholder's basis in their Subchapter S stock. Subsequent distributions will not result in taxation of the tax-exempt income." S. Rep. No. 97-640, 97th Cong., 2d Sess. 16 (1982), 1982-2 C.B. 718, 725.[7] The

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[7] This rationale for increasing shareholder basis is equally applicable to excluded COD income. In the case where an S corporation which is insolvent to the extent of $100 receives excluded COD income of $50, the corporation has received a benefit: rather than being insolvent to the extent of $100, it is now only insolvent to the extent of $50. At some point, the corporation may become solvent, and make distributions to its

parenthetical language contained in § 1366(a)(1)(A), specifically including "tax-exempt income" as income which may "affect" shareholder tax liability, can thus only mean that "tax-exempt" items are necessarily separately stated ***because*** of their effect on the shareholder's stock basis.

Just like tax-exempt interest, COD income is also a separately stated item of income under § 1366(a)(1)(A) because, although non-taxable, it has an effect upon basis (in the same manner as tax-exempt interest). However, unlike other nontaxable items, in the case of COD income, there is another means by which a shareholder's tax liability may be affected.

Under § 1366(d), where a shareholder's share of S corporation losses for any taxable year exceeds stock basis, the excess may not be deducted currently, but is "suspended" and carried to future periods. Section 108(d)(7)(B) provides that one of the attributes subject to reduction is shareholder losses suspended under § 1366(d). Shareholder's suspended losses are treated as if they were net operating losses ("NOLs"), the first item reduced pursuant to § 108(b) in the attribute reduction process. § 108(d)(7)(B). Suppose that an S corporation has two shareholders, A and B, whose ownership is A – 60% and B – 40%, and that these shareholders have losses suspended under § 1366(d)(1) in the amounts of A – $90 and B – $40. Now assume the corporation realizes $30 of excluded COD income. In the attribute reduction process, A would have his suspended losses reduced by $18 (60% of $30) to $72 and B would have his suspended losses reduced by $12 (40% of $30) to $28.

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shareholders. Then, unless there were a basis adjustment, the shareholders would be taxed upon that $50 difference ***in addition to*** any additional tax paid because of attribute reduction.

Clearly, COD income "may affect" the tax liability of shareholders: COD income may reduce shareholder-level suspended losses and result in an increase in the shareholders' subsequent year's taxes. Excluded COD income must then be taken into account by shareholders in the calculation of their stock basis.

B. The Government's Position Continues To Be A Moving Target.

While the Government's "item of income" argument was not raised in the Tenth Circuit, this argument is very similar to the Commissioner's argument before the Tax Court in the initial *Winn* case (*Winn v. Commissioner*, T.C.M. (RIA) 97,286). This argument was rejected by Judge Cohen in her initial opinion, and has not been raised subsequently in this litigation. The Commissioner moved for reconsideration in *Winn*, asking the Tax Court to consider alternative arguments. The initial *Winn* opinion was withdrawn and replaced by an opinion that followed the logic of those alternative arguments as adopted by the Tax Court in *Nelson*. *Winn v. Commissioner*, T.C.M. (RIA) 98,071, *aff'd sub nom., Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999).

On March 31, 2000, the Solicitor General acquiesced in our request for certiorari. On March 23, 2000, the Commissioner filed its Opening Brief in *Schmidt v. Commissioner*, Tax Court Dckt. No. 5505-99, attached as an Appendix to this Reply. Before this Court, the Government argues primarily that excluded COD income is not an "item of income." This argument is not found anywhere in the *Schmidt* brief. In contrast, in the Tax Court, the Commissioner relies extensively on the rationale presented in the *Nelson* opinion (by requiring exclusion "at the corporate level," § 108(d)(7)(A) precluded the §§ 1366 and 1367 pass through to shareholders). This argument appears nowhere in the Government's Brief in this Court. While the Government is free to pursue alternative arguments, the radical differences in position taken by the

government in briefs filed eight days apart, concerning an issue that has been the subject of significant litigation for more than three years, gives additional support to the Taxpayers' contention that the Government's arguments are based solely upon the result sought, and not upon the controlling statutory language.

RESPECTFULLY SUBMITTED this 26th day of April, 2000.

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APPENDIX

UNITED STATES TAX COURT

JAMES M. and SOPHIA L. SCHMIDT, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Docket No. 5505-99

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UNITED STATES TAX COURT

JAMES M. and SOPHIA L. SCHMIDT, Petitioners,	)	Docket No. 5505-99
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

This case involves a deficiency determination of $128,699 for the petitioners' 1994 taxable year.

This case was set for trial before the Honorable Robert P. Ruwe at the Seattle, WA, Trial Session beginning on February 7, 2000. At the calendar call, the case was submitted to the Court on a fully stipulated basis. The evidence consists of a Stipulation of facts (¶¶ 1-56) and attached exhibits (1-J through 7-J). The Court requested that the parties file simultaneous briefs. Opening briefs are due on March 23, 2000, and reply briefs are due on April 22, 2000.

The other issues raised by the notice of deficiency (i.e., the adjustments to itemized deductions and to the deduction for personal exemptions) are computational. Resolution of the principal issue will resolve these issues.

QUESTION PRESENTED

Whether discharge of indebtedness (COD) income excluded under I.R.C. § 108(a) from the gross income of an S corporation passes through to the S corporation's shareholders as an item of income under I.R.C. § 1366(a)(1)(A) and, in turn, increases the basis of the shareholders' corporate stock under I.R.C. § 1367.

RESPONDENT'S REQUEST FOR FINDINGS OF FACT

The respondent respectfully asks that the Court find the following evidentiary facts:

1. At the time their petition was filed, the petitioners' mailing address was 2 Grove Isle Drive, Unit 1208, Miami, Florida 33133-4112. (Stip. ¶ 1).

Experius Health Care, Inc. ($293,303 adjustment)

2. Petitioners owned 62.15% of Experius Health Care, Inc. (EHCI) in 1994. (Stip. ¶ 5).

3. EHCI was incorporated on 1/9/82. (Stip. ¶ 6).

4. At all relevant times, EHCI was an S corporation. (Stip. ¶ 8).

5. EHCI's primary activity involved the operation of a nursing home in Kansas City, Missouri. (Stip. ¶ 10).

6. EHCI ceased the foregoing operations in 1994. (Stip. ¶ 11).

7. As of 12/31/93, the petitioners had suspended ordinary losses (losses in excess of stock basis) attributable to EHCI in the amount of $488,086. (Stip. ¶ 12).

8. As of 12/31/93, the petitioners had suspended capital losses (losses in excess of stock basis) attributable to EHCI in the amount of $115,983. (Stip. ¶ 13).

9. As of 12/31/93, the petitioners had a zero stock basis in EHCI. (Stip. ¶ 14).

10. For 1994, the petitioners reported ordinary income from EHCI in the amount of $194,783. (Stip. ¶ 15).

11. In 1994, EHCI's and others debt of $2,234,705.44 to the FDIC was restructured and $1,108,385.02 was forgiven by the lender. (Stip. ¶ 17).

12. In 1994, EHCI and others realized $1,108,385.02 of COD income under the provisions of I.R.C. § 61(a)(12). EHCI's share of this COD income was $530,666.86. (Stip. ¶ 18).

13. The petitioners' pro rata share of the $530,666.86 (COD income) was $329,810. (Stip. ¶ 21).

14. At the time the $530,666.86 was realized by EHCI, it was insolvent by at least $530,666.86. (Stip. ¶ 19).

15. EHCI excluded the entire $530,666.86 of COD income from its gross income. (Stip. ¶ 20).

16. The petitioners claim to have increased their stock basis in EHCI in 1994 by the followng amounts:

Ordinary income flow-through:	$194,783
Pro rata share of income excluded under § 108 (i.e., of $530,666.86):	329,810
	$524,493

(Stip. ¶ 22).

17. In 1994, the petitioners deducted $488,086 of their suspended ordinary losses and $36,507 of their suspended capital losses ($488,086 + $36,507 = $524,593). (Stip. ¶ 23).

18. The petitioners were allowed to deduct $194,783 of their suspended ordinary losses (i.e., of the $488,086) in 1994 and the remainder (i.e., $293,303) was disallowed in the notice of deficiency. (Stip. ¶ 24).

19. The petitioners' $36,507 deduction attributable to suspended capital losses was also disallowed. (Stip. ¶ 25).

20. Absent the petitioners' $329,810 increase to stock basis (from the excluded income), the petitioners would not have had any stock basis to claim the disallowed losses of $293,303 and $36,507. (Stip. ¶ 26).

Experius Systems, Inc. ($16,216 adjustment)

21. The petitioners agree to the $16,216 adjustment attributable Experius Systems, Inc. (Stip. ¶ 27).

Capital Gains and Losses ($51,588 adjustment)

22. The $55,543 of disallowed losses (per Exhibit A to the notice of deficiency) are computed as follows:

Experius Corp (EIN: 73-1107554)

Suspended Capital Loss:	($13,576)
Allowed Loss:	6,762
Disallowed Capital Loss	6,814

EHCI (EIN: 36-3156614)

Disallowed Capital Loss (see above):	36,507

Long-Term Capital Loss Carryover from 1993 (per return):	12,222
TOTAL:	55,543

The adjustment of $51,588 is arrived at by subtracting certain capital losses claimed on the return. The computation is reflected on Exhibit A to the notice of deficiency. (Stip. ¶ 28).

23. The petitioners own 100% of Experius Corporation ("EC"). (Stip. ¶ 29).

24. At all relevant times, EC was an S corporation. (Stip. ¶ 31).

25. EC's primary activity involved investments. (Stip. ¶ 33).

26. As of 12/31/93, the petitioners had $16,455 of suspended capital losses (losses in excess of stock basis) in EC. (Stip. ¶ 34).

27. As of 12/31/93, the petitioners had a zero stock basis in EC. (Stip. ¶ 35).

28. In 1994, EC realized $13,576 of COD (forgiveness of indebtedness) income under the provisions of I.R.C. § 61(a)(12). (Stip. ¶ 36).

29. The petitioners reported $6,762 of the foregoing debt discharge income (as flow-through ordinary income). (Stip. ¶ 37).

30. EC excluded from income (and the petitioners did not report) $6,814 of the $13,576. (Stip. ¶ 38).

31. At the time EC realized the $13,576 of income, it was insolvent as to $6,814. (Stip. ¶ 39).

32. The petitioners claimed to have increased their stock basis by $13,576 in 1994 ($6,762 reported + $6,814 excluded). (Stip. ¶ 40).

33. The petitioners deducted $13,576 as a long-term capital loss in 1994. (Stip. ¶ 41).

34. Absent the petitioners' $6,814 increase to stock basis (from the excluded income), the petitioners would not have had any stock basis to claim the disallowed losses of $6,814. (Stip. ¶ 42).

35. The disallowed $12,222 relates to petitioners' involvement with St. Louis South Park, Inc. ("South Park"). (Stip. ¶ 43).

36. At all relevant times, the petitioners owned 33.33% of South Park. (Stip. ¶ 44).

37. At all relevant times, South Park was an S corporation. (Stip. ¶ 46).

38. South Park's primary activity involved the operation of a convalescent center. (Stip. ¶ 49).

39. South Park incurred substantial losses over the years, and became insolvent in 1993. (Stip. ¶ 50).

40. South Park ceased to carry on a business in 1993. (Stip. ¶ 51).

41. On 12/31/92, the petitioners had a zero stock basis in South Park. (Stip. ¶ 52).

42. The petitioners increased their stock basis in 1993 by $338,371. This amount was their pro rata share of COD income realized by South Park. (Stip. ¶ 53).

43. The foregoing $338,371 was excluded from gross income at the corporate level (and not reported by the petitioners). (Stip. ¶ 54).

44. Part of the $338,371 basis increase was utilized to deduct losses in 1993 and part (namely $12,222) was carried-over to 1994 by the petitioners and claimed as a long-term capital loss (from worthless stock). (Stip. ¶ 55).

45. Absent the petitioners' $338,371 increase to stock basis (from the excluded COD income), the petitioners would not have had any stock basis to claim the disallowed 1994 loss of $12,222 (referenced above). (Stip. ¶ 56).

ULTIMATE FINDINGS OF FACT

The respondent respectfully asks that the Court find the following ultimate facts:

46. The petitioners are not entitled to increase the basis of their stock in any of the S corporations at issue on account of the COD income excluded from the gross income of the S corporations.

47. Regarding EHCI, the petitioners are not entitled to deduct the disallowed suspended ordinary losses of $293,303 and the disallowed suspended capital losses of $36,507.

48. Regarding Experius Systems, Inc., the petitioners agree to the $16,261 adjustment. (Due to the agreement, facts germane to this issue will not be discussed below.)

49. Regarding EC, the petitioners are not entitled to deduct the disallowed suspended capital losses of $6,814.

50. Regarding South Park, the petitioners are not entitled to deduct the disallowed capital loss of $12,222.

POINTS RELIED UPON

Consistent with this Court's holding in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), the petitioners are not entitled to increase the bases of their stock in EHCI, EC and South Park by the excluded COD income relative to each corporation.

I.R.C. § 108 and the relevant subchapter S provisions work together to properly keep the excluded COD income at the corporate level (thereby denying a stock basis increase). In this regard, it cannot be disputed Congress intended for the excluded income of an S corporation to remain at the corporate level, on a deferred basis, in order to properly apply the attribute reduction provisions under I.R.C. § 108. The subchapter S provisions confirm this result by not providing for the flow through of deferred income to the shareholders of an S corporation.

The tax deferred nature of the excluded income is established by the I.R.C., legislative history, case law, and the only logical interpretation of the I.R.C. § 108 and subchapter S provisions. First, the reduction in tax attributes in I.R.C. § 108(b) clearly operates so that excluded COD income of a taxpayer will eventually be taxed on a deferred basis (via the elimination of net operating losses, reduced basis in assets, etc.). Second, Congressional

intent to defer the income recognition cannot be more clear in the legislative history underlying I.R.C. § 108. Third, both this Court and the Supreme Court have recognized and held that excluded COD income is tax-deferred income. Finally, no basis increase is warranted for the excluded COD income under the subchapter S provisions because, unlike tax-exempt income, there will generally not be a distribution to the shareholders resulting from same (i.e., a basis increase is not needed to preserve a "tax-exempt" characterization).

To the extent the excluded COD income exceeds tax attributes that it reduces, it has no further tax consequences. Not only is this result mandated by a proper construction of the relevant I.R.C. provisions, the legislative history underlying I.R.C. § 108 makes it perfectly clear the excluded COD income "is disregarded, i.e., does not result in income or have other tax consequences."

Another reason the petitioners should not be allowed to increase the basis of their stock in the subject S corporations is because they have not made the requisite economic outlay.

A close look at the two cases which have held for the taxpayers on this issue (*United States v. Farley*, 202 F.3d 198 (3rd Cir. 2000) and *Hoque v. United States*, No. 99-302-KI (D. Ore. Jan. 3, 2000)) reveals either an improper focus as to the controlling I.R.C. provisions or a misunderstanding as to what tax-exempt income is and why it is specifically listed as an item of income under I.R.C. § 1366(a).

In the end, the petitioners unwarranted stock basis increase – (a) is clearly inappropriate under the applicable authority, (b) creates deductions for the very item intended to be eliminated (i.e., the suspended losses at issue), and (c) impermissibly converts a tax deferral mechanism into a tax reduction mechanism.

ARGUMENT

I. COD INCOME EXCLUDED FROM GROSS INCOME BY AN S CORPORATION DOES NOT PASS THROUGH TO THE SHAREHOLDERS OF THE S CORPORATION AS AN ITEM OF INCOME UNDER I.R.C. § 1366(A) (1) AND DOES NOT INCREASE THE CORPORATE STOCK BASIS UNDER I.R.C. § 1367.

This case involves an attempt by the petitioners to obtain unwarranted double tax benefits from the insolvency of their subchapter S corporations. As explained below, the anomalous result sought by the petitioners has been rejected by this Court, is contrary to the relevant Internal Revenue Code provisions and legislative history relating thereto, and simply does not make sense when considering the statutory schemes involved.

A. *Nelson v. Commissioner*, 110 T.C. 114 (1998), was correctly decided.

In *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999), this Court correctly held that COD income excluded from gross income under I.R.C. § 108(a) does not pass through to the shareholder of an S corporation as an item of income under I.R.C.

§ 1366(a) (1) and, in turn, does not increase the basis of the shareholder's corporate stock under I.R.C. § 1367. In its well-reasoned opinion, this Court found support for its holding in the literal language of the applicable statutory provisions, in legislative history and in established case law. This Court has consistently followed its opinion in *Nelson*. *See, e.g., Winn v. Commissioner*, T.C. Memo. 1998-71; *Chesapeake Outdoor Enterprises, Inc. v. Commissioner*, T.C. Memo. 1998-175; *Friedman v. Commissioner*, T.C. Memo. 1998-196, *appeal docketed*, No. 98-2378 (6th Cir. December 17, 1998); *Gaudiano v. Commissioner*, T.C Memo. 1998-408, *appeal docketed*, No. 99-1294 (6th Cir. March 8, 1999); *Cronin v. Commissioner*, T.C. Memo. 1999-22, *appeal docketed*, No. 18408-99 (7th Cir. May 10, 1999); *Pugh v. Commissioner*, T.C. Memo. 1999-38, *appeal docketed*, No. 99-12646 (11th Cir. July 26, 1999); *Conviser v. Commissioner*, T.C. Memo. 1999-47; *Eberle v. Commissioenr*, T.C. Memo. 1999-287; *Goodman v. Commissioner*, T.C. Memo. 2000-21; *Mullen v. Commissioner*, T.C. Memo. 2000-23; *Bettisworth v. Commissioner*, T.C. Memo. 2000-30.

B. I.R.C. § 108 and the relevant Subchapter S provisions work together to properly keep the excluded COD income at the corporate level, thereby denying a stock bases increase.

In attempting to increase their stock bases in the various S corporations at issue, petitioners have misinterpreted the statutory frame work provided by I.R.C. §§ 61, 108, 1366 and 1367.

I.R.C. § 61(a) (12) provides that gross income includes income from the discharge of indebtedness.

I.R.C. § 108 provides exceptions to this general rule. As relevant here, I.R.C. § 108(a) (1) (B) provides that gross income does not include any amount which would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. There is, however, a cost for the exclusion of COD income. Under I.R.C. § 108(b) (1), the amount so excluded from gross income must be applied to reduce certain tax attributes of the taxpayer. Unless the taxpayer elects to apply this reduction first against the basis of its depreciable property, I.R.C. § 108(b) (2) requires that taxpayers apply the excluded amount to reduce the following tax attributes in the following order:

> (A) *NOL.* – Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
>
> (B) *General Business Credit.* – Any carryover to or from the taxable year of a discharge of an amount for purposes of determining the amount allowable as a credit under section 38. . . .
>
> (C) *Minimum Tax Credit.* – The amount of the minimum tax credit available under section 53 (b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
>
> (D) *Capital Loss Carryovers.* – Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
>
> (E) *Basis Reduction.* – * * * . The basis of the property of the taxpayer. * * * .

> (F) *Passive Activity Loss and Credit Carryovers.* – Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
>
> (G) *Foreign Tax Credit Carryovers.* – Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

I.R.C. § 108(b) (4) (A) provides that the reduction in tax attributes is made after the determination of the tax for the taxable year of the discharge.

Special rules for S corporations are contained in I.R.C. § 108(d) (7). First and foremost, I.R.C. § 108(d) (7) (A) provides that subsections (a), (b), (c), and (g) of I.R.C. § 108 shall be applied at the corporate level.[1] Also, for purposes of determining the appropriate net operating loss reduction under the attribute reduction provision, I.R.C. § 108(d) (7) (B) provides that any loss or deduction that is disallowed for the taxable year of the discharge under I.R.C. § 1366(d) (1) is treated as a net operating loss for such taxable year.[2]

When considering the provisions of I.R.C. § 108 discussed above, it cannot be disputed Congress intended for the excluded income of an S corporation to remain at

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[1] In contrast, I.R.C. § 108(d) (6) provides that these rules apply at the partner level in the case of a partnership.

[2] I.R.C. § 1366(d) (1) provides that losses and deductions taken into account by a shareholder of an S corporation for any taxable year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation plus the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

the corporate level in order to properly apply the attribute reduction provisions. The interpretation of I.R.C. § 108 proposed by the petitioners is plainly wrong. Under their approach, I.R.C. § 108 – (a) creates deductions for the very item it is intended to eliminate (i.e., losses suspended under I.R.C. § 1366(d) (1)), and (b) is converted from a tax deferral mechanism into a tax reduction mechanism. *See Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575 (1982) ("[I]nterpretations of a statute which would produce absurd results are to be avoided if alternative interpretations consistent with the legislative purpose are available.").

As indicated below, the relevant subchapter S provisions operate to confirm and carry-out the statutory scheme dictated by I.R.C. § 108. In doing so, the integrity of the overall purpose and goal of subchapter S is maintained.

The subchapter S passthrough scheme features a system by which corporate income, losses, deductions, and credits are passed through to shareholders. Section 1366 implements the passthrough scheme by providing rules addressing the tax consequences to shareholders for income realized by, and losses incurred by, the corporation. Section 1366(a) (1) provides:

> In determining the tax . . . of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's –

> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

Pursuant to I.R.C. § 1366(a), the S corporation allocates pro-rata shares of income (including tax-exempt income) and loss (the separate treatment of which could affect the tax liability of any shareholder) and nonseparately computed income or loss to its shareholders, who take the items into account in determining their tax liability. Because the excluded COD income is tax deferred income, not tax-exempt, and the reduction of tax attributes occurs at the corporate level, the excluded COD income is not allocated to the shareholders to pass through to them under I.R.C. § 1366(a). However, the shareholders take into account any COD income that was subject to (i.e., exceeded) the insolvency limitation under I.R.C. § 108(a) (3) at the corporate level and passed through to them.

A shareholder's basis in the shareholder's stock, initially established through an actual economic outlay, is a measure of the shareholder's tax investment in the corporation. Subsequent adjustments to basis are made pursuant to I.R.C. § 1367. Section 1367(a) (1) provides for increases in the basis of a shareholder's stock in an S corporation as follows:

> The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> > (A) the items of income described in [section 1366(a) (1) (A)],
> >
> > (B) any nonseparately computed income determined under [section 1366(a) (1) (B)]. . . .

Section 1367(a) (2) provides for decreases in the basis of a shareholder's stock in an S corporation as follows:

> The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
>
> > (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
> >
> > (B) the items of loss and deduction described in [section 1366(a) (1) (A)],
> >
> > (C) the nonseperately computed loss determined under [section 1366(a) (1) (B)]. . . .

Thus, each shareholder's pro rata share of income, including any non-excluded COD income subject to the limitation under I.R.C. § 108(a) (3) that passes through, increases each shareholder's stock basis for the taxable year of the discharge. In addition, each shareholder's pro rate share of losses that pass through, including any previously suspended losses discussed below, decrease

each shareholder's stock basis for the taxable year of the discharge.

Relative to losses, I.R.C. § 1366(d) (1) limits the aggregate amount of losses taken into account under I.R.C. § 1366(a) to the sum of the shareholder's adjusted basis in stock of the corporation plus adjusted basis in corporate debt owed to the shareholder. Losses disallowed under I.R.C. § 1366(d) (1) may be carried forward indefinitely and used when the shareholder increases the shareholder's basis in the corporation's stock or debt under I.R.C. § 1366(d) (2). Section 1366 (d) (2) provides that "[a]ny loss or deduction which is disallowed for any taxable year by reason of [I.R.C. § 1366(d) (1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder." Therefore, the shareholders can take into account any previously suspended losses treated as incurred in the year of the discharge, limited under I.R.C.§ 1366(d) (1) to the extent of any increases in their bases pursuant to I.R.C. § 1367(a) (1). Any previously suspended losses taken into account by a shareholder under I.R.C. § 1366(a) (1) will cause a decrease to that shareholder's stock basis pursuant to I.R.C. § 1367(a) (2).

The pass through of income and losses under I.R.C. § 1366(a) and any resulting adjustments to basis under I.R.C. § 1367 are effected before the reduction of tax attributes at the corporate level by the excluded COD income, which does not pass through to the S corporation shareholders. Thus, shareholders are allowed either losses incurred in the year of the discharge or losses previously suspended to the extent of their existing basis

in the stock of the S corporation or increased basis due to income passed through in the year of the discharge.

When the foregoing provisions of I.R.C. § 108 and subchapter S are considered together, it is clear the Code does not permit the petitioners to increase their stock basis in EHCI, EC and South Park by the excluded COD income relative to each corporation. First, income excluded under I.R.C. § 108 does not pass through from an S corporation to its shareholders because, under the design of I.R.C. § 108 (including the attribute reduction provisions), any excluded COD income is tax deferred income, not tax-exempt income. Since the excluded COD income is tax deferred income, the statutory provisions applicable to S corporations do not permit the pass-through of the excluded COD income to the petitioners.[3] Indeed, quite the opposite is required. Second, excluded COD income does not pass through an S corporation to its shareholders because of the literal language of I.R.C. § 108(d) (7). While these results are clear from the authority discussed above, a couple of the key points are further explained below.

1. Excluded COD income is tax deferred income, not tax-exempt income, and does not pass through to the shareholders of an S corporation.

Under I.R.C. § 108, excluded COD income does not pass through from an S corporation to its shareholders

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[3] If the income were tax-exempt income, such a passthrough to the shareholder would be required under I.R.C. § 1366(a) (1).

because, under the design of I.R.C. § 108, excluded COD income is tax deferred income, not tax-exempt income. Consequently, the statutory provisions governing S corporations do not provide for the passthrough of the excluded COD income to the shareholders. Support for this position is found in the operation of I.R.C. § 108 and in its legislative history.

As discussed above, the cost of the I.R.C. § 108 exclusion from income is that the taxpayer must reduce certain tax attributes by the amount of the COD income excluded from gross income in the current year. *See also Nelson v. Commissioner*, 110 T.C. at 129. Unless the taxpayer elects to apply this reduction first against the basis of its depreciable property, I.R.C. § 108(b) requires that the taxpayer apply the excluded amount to reduce its attributes in the order provided in I.R.C. § 108(b). The ordering rules for the reduction in tax attributes in I.R.C. § 108(b) operate so that excluded COD income of a taxpayer will eventually be taxed (via the eliminated net operating losses, reduced basis in assets, etc.). Consequently, excluded COD income is not tax-exempt income. Rather, recognition (and taxation) of excluded COD income is merely deferred to a later date.

Legislative history to the Bankruptcy Tax Act of 1980 clearly indicates the exclusion from income provisions under I.R.C. § 108 are intended to simply avoid immediate tax consequences by deferring the tax consequences to a later date. In this regard, the Senate Report provides: "To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy . . . is not burdened with *immediate tax*

consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 624 (emphasis added); *see also Nelson v. Commissioner*, 110 T.C. at 127. The Senate Report makes clear, however, the relevant provisions of I.R.C. § 108 (e.g., the attribute reduction provisions) are needed to ensure that the tax is only deferred and will eventually be paid:

> At the same time, in developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the *Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.*
>
> Thus present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debts to reduce the basis of non-depreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, *rather than deferring*, the tax consequences of debt discharge. * * * .
>
> Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.

S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 625 (emphasis added).

Case law relied upon by this Court in *Nelson* also supports the treatment of excluded COD income as tax deferred income, not tax-exempt income. In *United States v. Centennial Savings Bank*, 499 U.S. 573, 580 (1991), the

Supreme Court, in construing I.R.C. § 108, stated that "the effect of § 108 is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property." In its opinion, the Supreme Court repeatedly referred to the tax deferral mechanism in I.R.C. § 108. *See Centennial Savings Bank*, 499 U.S. at 582-83.

Because the income at issue was merely deferred, it is clearly not "tax-exempt income" which can pass through to a shareholder under I.R.C. § 1366. This notion was disposed of in the Court's *Nelson* opinion as follows:

> An exclusion that is subject to an offset (the tax attribute reductions) and may be subject to taxation in the future (that is, excluded from gross income *for the taxable year*) does not signify or indicate an item of income that is necessarily tax exempt on a permanent basis. In contrast, the language in section 103(a) expressly delineates that gross income does not include income derived from interest paid on any State or local bond. *See also Cotton States Fertilizer Co. v. Commissioner*, 28 T.C. 1169, 1172-1173 (1957) (discussion of "wholly exempt" from tax versus postponement of tax).

Nelson, 114 T.C. at 125 (emphasis in original).[4]

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[4] The Government's view is reflected in the preamble to Treas. Reg. § 1.1366-1(a)(2)(viii): " 'Tax-exempt income' does not include income from discharge of indebtedness excluded from income in all circumstances in which section 108 applies." I.R.B. 2000-2, T.D. 88-52 at 253.

The case cited in the foregoing excerpt, *Cotton States Fertilizer Co. v. Commissioner*, 28 T.C. 1169 (1957), involves the interplay of sections 24(a)(5), 112(f), and 113(a)(9) of the Internal Revenue Code of 1939 (predecessors of I.R.C. §§ 265 and 1033). In *Cotton States*, this Court held that the taxpayer, who had received insurance proceeds after two of its plants had been destroyed by fire, was entitled to deduct amounts paid to a firm of architects to recreate plans and specifications and to a contractor to estimate the replacement costs of the destroyed plants. In so holding, this Court rejected the Commissioner's arguments that the fire insurance proceeds were wholly exempt from income tax and that the payments to the architects and the contractor allocable to those proceeds were, therefore, nondeductible (the Commissioner relied on Treas. Reg. 111, § 29.24-4[5] for the proposition that exempt income is income which is not required to be included in gross income). Rather, this Court, observing that the taxpayer was required to decrease the basis of its new property by the amount of gain not recognized as income, concluded that the insurance proceeds were not wholly exempt from taxation. In this Court's opinion, the applicable code sections provided for the postponement (or deferral) of taxation. *Cotton States*, 28 T.C. at 1172. While *Cotton States* did not involve I.R.C. § 108, it does provide substantial support for the position that debt discharge income excluded under I.R.C. § 108(a) is tax deferred, not tax-exempt income.

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[5] The language of Treas. Reg. 111, § 29.24-4 is similar to the language in Treas. Reg. § 1.265-1(b).

"Tax-exempt income" is not defined in I.R.C. §§ 1366 and 1367. However, tax-exempt income implies permanency so that the income item is never subject to taxation. The reason tax-exempt income is included under I.R.C. § 1366(a) is simple. Without the specific inclusion under I.R.C. § 1366(a) (as a deemed flow-through item of income) there would not be a corresponding increase in basis under I.R.C. § 1367(a)(1) and, as a consequence, any subsequent distribution of the income to the S corporation's shareholders would effectively result in a taxable distribution under I.R.C. § 1368(b)(2). This would, in effect, cause the income to lose its "tax-exempt" status. *See Nelson*, 110 T.C. at 118. Conversely, no basis increase is warranted for excluded COD income because there will generally not be a distribution to the shareholders resulting from same and only a deferral of income not an exclusion is intended.

Given the authorities cited herein, a construction of I.R.C. §§ 1366(a)(1)(A) and 1367 that would allow an S corporation to pass through excluded COD income to its shareholders as tax-exempt, rather than tax deferred, income would not only nullify I.R.C. § 108(d)(7)(A), but it would also fly in the face of the Congressional intent in enacting the Bankruptcy Tax Act of 1980 and established case law. *See Nelson v. Commissioner*, 110 T.C. 114 (1998). Fortunately, the integrity of I.R.C. § 108 is maintained by the simple fact that the subchapter S provisions do not provide for tax deferred income to be passed through to the shareholders and increase the basis in their stock.

2. To the extent there are insufficient tax attributes to reduce, the excluded COD income has no further tax consequences.

The legislative history with respect to I.R.C. § 108 specifically indicates that any amount of COD income remaining after the attribute reductions "is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), 1980-2 C.B. 620, 620-21, 626; *see also Nelson v. Commissioner*, 110 T.C. at 128. Hence, not only is it clear that the income used to reduce tax attributes does not pass through to the shareholders of an S corporation, it is also clear any "leftover" income can not have the "tax consequence" sought by petitioners (i.e., an increase in stock basis). Simply put, after the application of I.R.C. § 108(b) and the resulting reduction of tax attributes there are no "items of income," tax-exempt or otherwise, to which I.R.C. § 1366(a) may apply. This makes sense given that the passthrough under I.R.C. § 1366(a) precedes the tax attribute reduction under I.R.C. § 108(b). *See Nelson*, 110 T.C. at 128 ("[T]o the extent that COD income exceeds the tax attributes that are reduced, or if there are no attributes to reduce, such 'excess' income does not go through the corporate form to the subchapter S shareholders, pursuant to section 1366(a)(1)(A).").

3. The literal language of I.R.C. § 108(d)(7)(A) mandates that subsections (a) and (b) of I.R.C. § 108 apply at the S corporation level, not at the shareholder level.

The language of I.R.C. § 108(d)(7)(A) is unambiguous in requiring that subsections (a), (b), (c), and (g) of I.R.C. § 108 be applied at the corporate level of an S corporation. Consequently, an S corporation must apply the exclusion from income rules under I.R.C. § 108(a) at the corporate level, and it must apply the reduction in tax attribute rules under I.R.C. § 108(b) at the corporate level. In this manner, I.R.C. § 108(d)(7)(A) operates as an exception to the general pass through design applicable to S corporations and their shareholders. The Court's *Nelson* opinion provides a succinct explanation of this point:

> [I]t is well established that a specific statutory provision will override a general provision. Hence, we believe that section 108(d)(7)(A) regulates the treatment of excluded COD income in the context of the subchapter S regime (i.e., sections 1363(a), 1366(a), and 1367(a)). * * * .
>
> The literal language at issue here provides that the reduction in tax attributes applies at the corporate level. Sec. 108(d)(7)(A). We do not interpret section 108(d)(7)(A) in a narrow manner. Here, we construe the provision to mandate that insolvency is determined – and COD income is excluded from gross income of an S corporation under section 108(a) – at the *corporate* level.

Nelson v. Commissioner, 110 T.C. at 121 (citations omitted; emphasis in original).

The legislative history of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, reveals the intent to exclude the income at the corporate level and, thereby, avoid a premature basis increase. In that statute, Congress extended the section 108 exclusion to income from discharge of "qualified real property business indebtedness." *See* I.R.C. § 108(a)(1)(D). The amount excluded under I.R.C. § 108(a)(1)(D) is applied to reduce the basis of the depreciable real property of the taxpayer. I.R.C. § 108(c)(1)(A). The House Report explains the effect of the excluded income on a shareholder's basis in the stock of an S corporation as follows:

> In applying this provision to income from the discharge of indebtedness of an S corporation, the election is made by the S corporation (sec. 1363(c)), *and the exclusion and basis reduction are both made at the S corporation level* (sec. 108(d)(7)). *The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level.* As a result of these rules, if an amount is excluded from the income of an S corporation under this provision, the income flowing through to the shareholders will be reduced (compared to what the shareholders' income would have been without the exclusion). Where the reduced basis in the corporation's depreciable property later results in additional income (or a smaller loss) to the corporation because of reduced depreciation or additional gain (or smaller loss) on disposition of the property, the additional income (or smaller loss) will flow through to the shareholders at that time, and will then result in a larger increase (or smaller reduction) in the shareholder's basis than if this provision had not previously

> applied. *Thus, the provision simply defers income to the shareholders.*

H.R. Rep. No. 103-111, 103rd Cong., 1st Sess. 624-625, 1993 U.S.C.C.A.N. 378, 855-856 (emphasis added).

The petitioners' contention that the excluded COD income flows through to the shareholders prior to any tax attribute reduction essentially nullifies I.R.C. § 108(d)(7)(A). By improperly flowing the "income" through to the shareholders prior to attribute reduction, the excluded COD income will *never* be available to reduce attributes "at the corporate level" as contemplated by I.R.C. § 108(d)(7)(A). The requisite attribute reduction can only take place if either – (a) the excluded COD income remains at the corporate level on a deferred basis, or (b) the attribute reduction takes place prior to the flow through of the excluded COD income. As indicated elsewhere in this brief, Congress specifically chose the former approach.

C. Petitioners are not entitled to increase the subject stock basis because there was no genuine economic outlay for this amount.

In its *Nelson* opinion, this Court mentioned the lack of economic outlay as another reason why the petitioner was not entitled to increase his stock basis:

> Here, petitioner has not borne an economic cost. On the contrary, it would appear that the economic cost was to others, the creditors of the corporation. Nor has petitioner made an economic outlay. Section 108 allows an insolvent S corporation to receive discharge of indebtedness income sheltered from immediate taxation to its

> shareholders. To permit petitioner to increase basis in the stock of the corporation on account of such tax-deferred income would produce a windfall to him.

Nelson, 110 T.C. at 128. The petitioners in this case also did not make an economic outlay for the stock basis they seek.

The petitioners did not contribute (or pay tax on for that matter) any of the amounts for which they seek an increase in stock basis. Rather, the petitioners contend they are entitled to increase the stock basis solely by reason of the excluded COD income. To allow such an increase in basis would be an abuse of the tax law, which requires that a shareholder make a genuine economic outlay to increase the basis in his or her stock.[6]

In order for a shareholder to increase the basis of his or her stock in an S corporation or in debt owned by the S corporation to him or her, the shareholder must make a genuine economic outlay. *Bergman v. United States*. 174 F.3d 928 (8th Cir. 1999); *Bolding v. Commissioner*, 117 F.3d 270 (5th Cir. 1997); *Uri v. Commissioner*, 949 F.2d 371, 373 (10th Cir. 1991); *Estate of Leavitt v. Commissioner*, 875 F.2d 420, 422 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989); *Hitchins v. Commissioner*, 103 T.C. 711, 715 (1994). An economic outlay can be accomplished only by the flow of

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[6] Under I.R.C. § 1366(d), the aggregate amount of losses and deductions which can be taken into account by an S corporation shareholder for any taxable year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

money or property from the shareholder to the corporation. This can be done by a contribution of cash or property to the corporation which increases the shareholder's basis in his stock, or by the shareholder loaning money or property to the corporation. The courts have strictly interpreted the requirement of a genuine economic outlay. *Id.* In this regard, *Estate of Leavitt* holds:

> To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay on the part of the shareholder. A guarantee, in and of itself, cannot fulfill that requirement. The guarantee is merely a promise to pay in the future if certain unfortunate events should occur. At the present time, the appellants have experienced no such call as guarantors, have engaged in no economic outlay, and have suffered no cost.

Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 (4th Cir. 1989).

In the instant case, petitioners ask for a basis increase in the stock of each of their S corporations at issue (EHCI, EC and South Park) even though they made no such economic outlay. To allow such a basis increase without an economic outlay by the petitioners would effectively allow the petitioners to erect a "tax shelter" using the subchapter S provisions. This was never intended by Congress, and the prevention of such a result was specifically provided for in the subchapter S provisions. *See Estate of Leavitt v. Commissioner*, 90 T.C. 206, 217 (1988) (case decided under former I.R.C. § 1374), *aff'd*, 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989).

D. The timing of attribute reduction does not control the outcome of this case.

In addressing whether excluded COD income passes through to the shareholders of an S corporation as an item of income to increase their corporate stock basis, some court decisions have identified the timing of the tax attribute reduction pursuant to I.R.C. § 108(b)(4)(A) as determinative. The special rule of I.R.C. § 108(b)(4)(A) provides that the reduction of tax attributes occurs after the determination of tax imposed for the taxable year of the discharge. The focus of the court decisions has been on whether, under this special rule, the reduction occurs during the taxable year of the discharge, before the corporation passes through income or losses; or the year following the discharge, after the corporation has passed through income and losses, including the excluded COD income. The Tenth Circuit in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *aff'g, Winn v. Commissioner*, T.C. Memo. 1998-71, and the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), aff'g, T.C. Memo. 1999-64, have concluded that pursuant to I.R.C. § 108(b)(4)(A), the excluded COD income is applied to reduce tax attributes at the corporate level during the taxable year of the discharge and before income and losses pass through from the S corporation to its shareholders. The Third Circuit in *Farley* has concluded that the provision requires that the reduction of tax attributes takes place after the taxable year of the discharge. Because the Third Circuit treated the excluded COD income as tax-exempt income, it passed through to shareholders to increase their stock basis for the taxable year of the discharge, thus allowing them to use suspended

losses that would otherwise be treated as a tax attribute to be reduced.

Taken together, the statutory provisions under I.R.C. § 108 relating to the tax attribute reduction are not clear as to the timing of that reduction. The section provides that the reduction takes place "after the determination of the tax imposed by this chapter for the taxable year of the discharge." Relevant to reducing the tax attributes of S corporations, I.R.C. § 108(b)(2)(A) requires an S corporation to apply the excluded amount to reduce first any NOL "for the taxable year of the discharge," and any NOL "carryover to such taxable year." Section 108(b)(2)(E) then requires the S corporation apply any remaining excluded amount to the basis of the property of the taxpayer pursuant to I.R.C. § 1017. Also invoking I.R.C. § 1017, I.R.C. § 108(b)(5) provides that the taxpayer may elect to apply any portion of the tax attribute reduction to the reduction under I.R.C. § 1017 of the basis of the depreciable property of the taxpayer. Section 1017 specifically provides that if the tax attribute reduced is the basis of the taxpayer's property, as opposed to an NOL, then such reduction of basis shall apply to any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. At best, the language of 108(b)(4)(A) is not clear or free from ambiguity.

The Circuit Courts' focus on the special rule of I.R.C. § 108(b)(4)(A) is misplaced, however. The timing of the corporate-level tax attribute reduction is irrelevant to the issue of whether shareholders get to increase their stock bases for excluded COD income, because the excluded COD income is tax deferred income, not tax-exempt

income, and does not pass through to shareholders. Thus, whether the reduction of tax attributes occurs at the end of the taxable year of the discharge or the beginning of the year following, the excluded COD income never passes through to increase the bases in the petitioners' stock, but remains at the corporate level to apply against the corporation's tax attributes.

The language of 108(b)(4)(A) is subject to different interpretations (as evidenced from the several Circuit decisions) only if excluded COD income is allowed to pass through to the shareholders. Otherwise, I.R.C. § 108(b)(4)(A) merely ensures that the tax attribute reduction is the final step an S corporation takes relative to the tax items for the taxable year of the discharge, whichever year it occurs. As in this case, this allows a shareholder to utilize any basis created during the year of discharge.

The following demonstrates the irrelevance of the timing of the tax attribute reduction under I.R.C. § 108(b)(4)(A) to the issue in this case. For the taxable year of a discharge, an S corporation computes its taxable income at the end of the taxable year, but is not subject to taxes pursuant to I.R.C. § 1363(a). COD income that is considered income under I.R.C. § 61(a)(12) is excluded from gross income under I.R.C. § 108(a)(1)(B) if the S corporation is insolvent. Pursuant to I.R.C. § 108(d)(7)(A), the exclusion of COD income from gross income is applied at the corporate level, thus, the determination of insolvency is made at the corporate level, not the individual shareholder level. Besides its COD income, the corporation computes its other income and losses for the taxable year of the discharge. In computing its income, the corporation makes its corporate-level determination

of insolvency pursuant to I.R.C. 108(d)(7)(A), and excludes the COD income from its gross income under I.R.C. § 108(a)(1)(B), subject to the insolvency limitation under I.R.C. § 108(a)(3). Any COD income in excess of the limitation is not subject to the exclusion under I.R.C. § 108(a)(1)(B) and should be includible in the gross income of the S corporation, unless otherwise excludible.

I.R.C. § 1366(a) provides that certain items of income of an S corporation are passed through to the shareholders of the S corporation. As relevant here, I.R.C. § 1366(a)(1)(A) defines an S corporation's separately stated items as "items of income (including tax-exempt income), loss, deduction, or credits the separate treatment of which could affect the liability for tax of any shareholder." The character of the item is determined as if the item were realized directly from the source from which realized by the corporation, or incurred in the same manner as the corporation. I.R.C. § 1366(b). The excluded COD income is not allocated to the shareholders and passed through to them because it is tax deferred income, not tax-exempt income, and the reduction of tax attributes occurs at the corporate level. I.R.C. § 1367(a)(1) provides that a shareholder's basis in the stock of an S corporation is increased by, among other things, the passthrough items of income described in I.R.C. § 1366(a)(1)(A), including tax-exempt income.

In terms of the timing of attribute reduction relative to losses, I.R.C.§ 1366(d)(1) limits the aggregate amount of losses taken into account under I.R.C. § 1366(a) to the sum of the shareholder's adjusted basis in stock of the corporation plus adjusted basis in corporate debt owed to the shareholder. Losses that are disallowed under I.R.C.

§ 1366(d)(1) may be carried forward indefinitely and used when the shareholder increases the shareholder's basis in the corporation's stock or debt under I.R.C. § 1366(d)(2). Section 1366(d)(2) provides that "[a]ny loss or deduction which is disallowed for any taxable year by reason of [I.R.C. § 1366(d)(1)] shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder." Therefore, the shareholders can take into account any previously suspended losses treated as incurred in the year of the discharge, limited under I.R.C. § 1366(d)(1) to the extent of any increases in their bases pursuant to I.R.C. § 1367(a)(1). Any previously suspended losses taken into account by a shareholder under I.R.C. § 1366(a)(1) will cause a decrease to that shareholder's stock basis pursuant to I.R.C. § 1367(a)(2). The pass through of income and losses under I.R.C. § 1366(a) is effected before the reduction of tax attributes at the corporate level by the excluded COD income, which does not pass through to the S corporation shareholders. Thus, shareholders are allowed either losses incurred in the year of the discharge or losses previously suspended to the extent of their existing basis in the stock of the S corporation or increase basis due to income passed through in the year of the discharge.

Finally, the S corporation must determine, at the corporate level, its tax attributes, including any suspended losses of the shareholders treated as NOLs, to be reduced under I.R.C. § 108(b) by the excluded COD income. Section 108(d)(7)(B), a special rule establishing one type of tax attribute for S corporations, confirms that the reduction of tax attributes follows the pass through of income

and losses. Section 108(d)(7)(B) provides that for purposes of reducing the NOL tax attribute for S corporations, "any loss or deduction which is disallowed for the taxable of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year." Under this provision, only losses that are disallowed for the taxable year of the discharge are treated as a corporate-level NOL. These losses could include not only those actually incurred in the year of the discharge, but also those previously suspended but treated as incurred in the year of the discharge, either of which may be disallowed under I.R.C. § 1366(d)(1) for the taxable year of the discharge. Only after an S corporation determines which losses are disallowed for the taxable year of the discharge can the S corporation establish its NOL tax attribute under I.R.C. § 108(d)(7)(B). Any losses of the shareholders in excess of their bases will be disallowed under § 1366(d)(1) and treated as a corporate level NOL under I.R.C. § 108(d)(7)(B). Pursuant to I.R.C. § 108(b)(2)(A), the S corporation first applies the excluded COD income to reduce this NOL tax attribute for the taxable year of the discharge. The S corporation then reduces its other tax attributes by the excluded COD income in the order prescribed under I.R.C. § 108(b)(2), assuming no election is made to first reduce basis in depreciable property.

By way of example, assume that an S corporation, with a sole shareholder, is financially distressed and has its debt discharged for the taxable year. The amount of the discharged debt for the taxable year equals $125. Assume further than the shareholder has a basis in his S corporation stock of $0 and $90 of suspended losses from previous taxable years. Moreover, the S corporation is

insolvent in the amount of $75. For the taxable year of the discharge, the S corporation has no other income or losses.

The S corporation first computes its income for the taxable year of the discharge. Under I.R.C. § 61(a)(12), the S corporation potentially has $125 of COD income. However, applying I.R.C. § 108(a)(1)(B) at the corporate level, the S corporation qualifies for the insolvency exclusion. Because of the limitation under I.R.C. § 108(a)(3), the S corporation limits its excluded COD income under I.R.C. § 108(a)(1)(B) to $75, and treats the remaining $50 as COD income. The S corporation then passes through the $50 of COD income to its shareholder under I.R.C. § 1366(a)(1), while the $75 of excluded COD income remains at the corporate level for the S corporation to apply against its tax attributes.

Pursuant to I.R.C. § 1366(a), the shareholder takes the $50 of passthrough COD income into account in determining his tax liability. Under I.R.C. § 1367(a)(1), the shareholder then increases the $0 basis in his S stock by the $50 of COD income, resulting in a new basis in his S corporation stock of $50. At the same time, the shareholder treats his $90 of previously suspended losses as incurred in the year of the discharge under I.R.C. § 1366(d)(2). Because the basis limitation under I.R.C. § 1366(d)(1) limits losses taken into account for the taxable year to the shareholder's basis in his stock, he may take into account only $50 of the previously suspended losses for the taxable year of the discharge. The remaining $40 of previously suspended losses are disallowed for the taxable year of the discharge.

Finally, the S corporation reduces its tax attributes by the excluded COD income at the corporate level. The shareholder's $40 of previously suspended losses that are disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1) are treated as a NOL of the corporation under I.R.C. § 108(d)(7)(B). The S corporation applies the $75 of excluded COD income to reduce this $40 corporate-level NOL tax attribute. The remaining $35 of excluded COD income is used by the S corporation to reduce its other tax attributes in the order prescribed under I.R.C. § 108(b)(2). Any remaining excluded COD income will have no further effect.

E. The authority relied upon by the petitioners in their Trial Memorandum is not helpful in resolving the issue.

While the respondent will have to wait until reciept of the petitioners' opening brief to fully understand their position, a couple of points raised in petitioners' Trial Memorandum warrant a brief discussion.

First, rather than addressing the merits of the *Nelson* opinion, the petitioners devote the bulk of their Trial Memorandum to the problems they perceive with the 10th Circuit's opinion in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *aff'g, Winn v. Commissioner*, T.C. Memo. 1998-71.[7] The criticism is directed primarily at the

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[7] The petitioners' discussion of the *Nelson* opinion primarily relies upon false and unfounded assertions such as the following: "In truth and in fact, the real reason that the . . . tax Court held for the government in *Gitlitz* and

10th Circuit's analysis of the timing of attribute reduction under I.R.C. § 108(b)(4)(A):

> In reaching its conclusion in *Gitlitz*, the Tenth Circuit relied primarily upon a timing statute, § 108(b)(4)(A), and interpreted that statute to provide that attribute reduction occurs *during* the taxable year of debt discharge and prior to the required passthrough of all items of S corporation income.

(Trial Memo. for Petitioners, p. 7; emphasis in original). The petitioners' perceived problems with the 10th Circuit's opinion should not factor into the analysis in this case, at least at this juncture, as – (1) the analysis herein is in line with the *Nelson* opinion and does not rely on the 10th Circuit's timing rationale, and (2) the facts of this case do not indicate that the attribute reduction approach condoned by the 10th Circuit was even utilized by respondent.[8]

Recent case law in this area warrants further discussion. In *United States v. Farley*, 202 F.3d 198 (3rd Cir. 2000), taxpayers invested in two S corporations, SCI Acquisition, Inc. and CCI Camping Corporation. By the end of

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Nelson . . . was not that the statutory language compelled the position of the Commissioner, but rather because the court[ ] apparently feared that the taxpayer's position would result in a 'windfall'." (Trial Memo. for Petitioners, p. 13.

[8] As to the latter point, the agreed facts dealing with EHCI (Stip. ¶¶ 5-26) show that respondent clearly did not utilize all of the COD income (i.e., $530,666.86) to offset the petitioners' claimed losses (totaling $604,069), thereby entitling them to claim $73,402 of their suspended losses (as opposed to the $197,783 allowed due to ordinary income flow-through).

1987, the taxpayers' basis in the S corporations had been reduced to zero, because of loss passthroughs. From 1987 through 1992, the S corporations continued to incur losses, which were suspended. In 1992, the S corporations were insolvent and ceased to operate. Secured creditors of the S corporations foreclosed on the corporate assets and forgave any unsatisfied debts. This resulted in COD income to the S corporation which it excluded from its gross income. Taxpayers increased their bases by the excluded COD income, and received refunds from the Service. The Service subsequently filed suit to recover the erroneous refunds. The Third Circuit in *Farley* reversed the district court holding that COD income excluded by taxpayers' S corporations passed through to them and increased their basis in the stock, allowing the deduction of suspended losses.

In holding for the taxpayers, the Third Circuit concluded that excluded COD income is tax-exempt income, that passes through to shareholders and raises their stock basis, allowing them to offset suspended losses against this basis. The court construed section 108(b)(4)(A) to order that the taxpayer's tax attributes were reduced by section 108(b)(1) in the year following the year of discharge. The court rejected the government's contention that the income was tax deferred rather than tax-exempt and, thus, did not pass through at all (regardless of the timing), stating that all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation under section 1366(a)(1)(A).[9]

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[9] A couple of the more obvious problems with the *Farley* analysis are – (1) it really doesn't focus on whether or not the

It is the Commissioner's position that, regardless of the timing of the tax attribute reduction, the excluded COD income does not pass through to increase the basis of the S corporation stock because it is tax deferred, not tax-exempt income. However, it is also the Commissioner's position that suspended losses may be offset (i.e., utilized) in the year of the discharge by basis not linked to excluded COD income.

Even if a case can be made that the plain language of the relevant I.R.C. provisions support the taxpayers in *Farley*, the respondent believes the Third Circuit court did not properly take into account the statutory construction interpretation set forth by the Ninth Circuit in *Albertson v. Commissioner*, 42 F.3d 537 (9th Cir. 1994), *cert. denied*, 516 U.S. 807 (1995). In *Albertson*, the Ninth Circuit stated:

> We may not adopt a plain language interpretation of a statutory provision that directly undercuts the clear purpose of the statute. In *Brooks v. Donovan*, 699 F.2d 1010 (9th Cir. 1983), we refused to adopt a plain language interpretation of a statute governing pension funds. We reasoned that the "court must look beyond the express language of a statute where a literal

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excluded income properly passes through to a shareholder; rather, it hinges its determination on the timing of attribute reduction ("If the reduction occurs after the pass through of COD income . . . then the shareholders of an S corporation can adjust their basis upward and deduct the otherwise undeductable loses."), and (2) it appears to equate the excluded income at issue with "tax-exempt income" ("Put simply, discharge of indebtedness income, if treated like tax-exempt interest, passes through to the shareholders of an S corporation and increases the shareholder's basis in the stock.").

> interpretation 'would thwart the purpose of the overall statutory scheme or lead to an absurd or futile result.' " . . . [T]he [Supreme] Court noted that "[w]hen [a given] meaning has led to absurd results . . . this Court has looked beyond the words to the purpose of the Act. Frequently, however, *even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole,' this Court has followed that purpose, rather than the literal words.*"

Id. at 545 (citation omitted; emphasis in original). The Ninth Circuit in *Albertson* also stated:

> [W]e take heed of the Supreme Court's instructions concerning the proper interpretation of the Internal Revenue Code when the plain language of the provisions leads to an unreasonable result and directly contradicts its underlying purpose: the provision "*must* be analyzed and construed within the framework of the Internal Revenue Code and against the background of the congressional purposes."

Id. at 546 (emphasis in original).

In addition, the rationale of the Seventh Circuit in *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), *aff'g*, T.C. Memo 1999-64, conflicts with both the Tenth Circuit's opinion in *Gitlitz* and the Third Circuit's opinion in *Farley* as well as the Tax Court's position in *Nelson* and its progeny. In *Witzel*, taxpayers were the sole shareholders of an S corporation that filed for bankruptcy in 1991. Through bankruptcy, the S corporation received $5.4 million in excluded COD income. Taxpayers increased their stock basis by the $5.4 million of excluded COD income

and deducted $2.5 million in suspended losses. The Commissioner disallowed the deduction, determining that the S corporation's excluded COD income could not increase taxpayers' stock basis. The Tax Court agreed. *Witzel v. Commissioner,* T.C. Memo. 1999-64. The Seventh Circuit concurred with the Tax Court that COD income reduces the taxpayers' tax attributes at the corporate level. In dicta, however, the court indicated that it disagreed both with the Tax Court's opinion in *Nelson* and the Supreme Court's analysis in *United States v. Centennial Savings Bank FSB,* 499 U.S. 573, 580 (1991), that excluded COD income is tax deferred, not tax-exempt income. Therefore, after the tax attribute reduction, excluded COD income may flow down to the taxpayer. This dicta conflicts with the Commissioner's position that excluded COD income is not tax-exempt and does not increase the basis of S corporation stock even after tax attributes have been offset. Application of the dicta in *Witzel* creates a windfall for taxpayers in subsequent years when they receive the benefit of increased basis from COD income.

Finally, in *Hogue v. United States,* No. 99-302-KI (D. Ore. Jan. 3, 2000), the district court held for the taxpayers on a similar section 108 issue. James Hogue owned 50 percent of the shares of Beaver Coaches, Inc., ("BCI"), an S corporation. The remaining 50 percent of BCI was owned by Frank and Linda Storch, the other plaintiffs in the suit. As the result of an involuntary bankruptcy petition filed against BCI (under Chapter 7 of the Bankruptcy Code, Title 11), BCI was relieved of debt in the amount of $1,849,923. This COD income was realized by BCI in 1994.

The district court held for the taxpayers stating that the COD income passed through to the shareholders

under I.R.C. § 1366(a)(1) and increased their basis under I.R.C. § 1367. The court further concluded that the tax attributes of BCI were decreased in 1995 pursuant to I.R.C. § 108(b). In so ruling, the district court disagreed with the analysis set forth by the Tenth Circuit in *Gitlitz*.[10]

In reaching its determination, the district court stated: "[A]lthough we should try to avoid double tax benefits, courts must leave them standing if the code positively requires this outcome." Thus, the district court appeared to recognize that the taxpayers were receiving a windfall.

We do not believe that the plain meaning of the statute causes the result asserted by the taxpayers and found by the district court. But even if a case could be made that the plain language did support the taxpayers and the district court, we believe that the above analysis of the statutory scheme and the legislative history clearly shows that Congress did not intend this result and that the taxpayers would receive a windfall that was not intended.

---

[10] One of the primary problems in the District Court's determination that excluded COD income generates basis was the Court's unjustified reliance upon the following conclusion: "Once the COD income is excluded, it is treated as tax-exempt income for purposes of section 1366(a)(1) and is passed through under that section." As indicated earlier in this brief, the excluded income is clearly not "tax-exempt."

CONCLUSION

It follows that the determination of the Commissioner of Internal Revenue should be sustained.

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JUN 29 2000

CLERK

No. 99-1295

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation which obtained a discharge of indebtedness. Income with respect to this cancellation of debt ("COD") was excluded from gross income under 26 U.S.C. § 108(a). The question presented in this case is whether excluded COD income is an item of income within the meaning of 26 U.S.C. § 1366(a)(1)(A), which increases Petitioners' basis in their S corporation stock pursuant to 26 U.S.C. § 1367.

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I. LOWER COURT OPINIONS

The United States Tax Court issued an initial opinion on June 24, 1997, reported at T.C.M. (RIA) 97,286. App. 25.[1] Subsequently, that opinion was withdrawn, and the Tax Court issued a revised opinion, which was filed on February 19, 1998 and reported at T.C.M. (RIA) 98,071. App. 21. The Tenth Circuit affirmed the Tax Court in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999). App. 1.

II. JURISDICTION

The Commissioner of the Internal Revenue issued Notices of Deficiency to Petitioners Gitlitz and Winn who timely petitioned the Tax Court to review the proposed deficiencies. App. 59 and App. 75. The Tax Court had jurisdiction under §§ 6212, 6213, 6214, and 7442 of the Internal Revenue Code (Title 26).[2] The Petitioners filed timely notices of appeal on April 27, 1998. The Tenth Circuit's jurisdiction arose under § 7482(a)(1). The Tenth Circuit's decision was entered on July 6, 1999, and Petitioners' Petition for Rehearing was denied on November 3, 1999. App. 32. The Petitioners Petition for Writ of Certiorari was timely filed on February 1, 2000 and granted by this Court, which has jurisdiction pursuant to 28 U.S.C. § 1254(1).

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[1] Citations to "App." refer to the Appendix attached to Petitioners' Petition for Writ of Certiorari.

[2] All subsequent citations to the "Code" refer to the Internal Revenue Code of 1986, Title 26 of the United States Code. All statutory citations, unless otherwise specified, refer to that Title. Citations to Regulations or Treasury Regulations refer to 26 C.F.R.

III. STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 108, 1366, and 1367 of the Code are set forth at App. 34, App. 52, and App. 56, respectively. Subsections (a) through (d) of § 1.1367-1 of the Treasury Regulations are set out in the Appendix to this brief (Merits Brief Appendix or "MBA") at MBA:1.

IV. STATEMENT OF THE CASE

The facts are not in dispute, and are described in the parties' cross motions for summary judgment filed with the Tax Court. Documents Nos. 6, 7, 8, 12, and 13 in Tax Court Docket Nos. 5359-96 (Winn) and 5358-96 (Gitlitz).[3] Petitioners David Gitlitz and Philip Winn (collectively, with their spouses, the "Taxpayers") were shareholders of P.D.W.&A., Inc. ("PDW&A"), a corporation which had elected to be taxed pursuant to Subchapter S of the Code. In 1991, PDW&A realized cancellation of debt ("COD") income in the amount of $2,021,296. At the time, PDW&A was insolvent to the extent of $2,181,748. Sections 108(a)(1)(B) and 108(d)(7)(A) permitted PDW&A to exclude the entire amount of the cancelled indebtedness from its gross income.

---

[3] The filed briefs and motions in the two Tax Court cases (*Gitlitz v. Commissioner*, Tax Court Docket No. 5389-96, and *Winn v. Commissioner*, Tax Court Docket No. 5358-96) were virtually identical (only the names differed) and the pleadings have identical docket numbers. The cases were ultimately consolidated for purposes of briefing. For convenience, the term "Document No." refers to the records (identical) in both Tax Court cases.

Subchapter S of the Code (26 U.S.C. § 1361 *et seq.*) allows shareholders of qualifying corporations to elect a "passthrough" system of taxation. Under this system, income, losses, deductions, and credits of the corporation "pass through" and are directly attributed to the shareholders. *Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). With some specific exceptions, income, expenses, and other tax-related items realized by an S corporation are passed through to the corporation's individual shareholders in a manner that is similar to the tax treatment of partnerships. *Compare* §§ 1366 and 1367 *with* §§ 704 and 705. Under this passthrough system of taxation, income is subjected to only a single level of taxation.[4] The shareholders report on personal tax returns their *pro rata* share of S corporation income, irrespective of whether there was any actual distribution of money to the shareholder. If an item of income is taken into account when determining the shareholder's taxable income, the shareholder's basis in his or her stock in the S corporation is increased by that amount. §§ 1366(a) and 1367(a). Items of income that are not subject to tax, such as municipal bond interest, are likewise added to a shareholder's basis, provided such income items could have an effect upon a shareholder's tax liability.

Corporate losses and deductions are also passed through to the shareholder. However, a shareholder cannot take corporate losses and deductions into account on his or her personal tax return to the extent that such

---

[4] This passthrough system differs significantly from the Code rules governing ordinary C corporations, where the corporation pays income tax on corporate income under § 11, and the individual shareholders pay tax on distributions. § 61(a)(7); §§ 301-307.

items exceed basis. § 1366(d)(1). If corporate losses and deductions allocated to the shareholder exceed basis, the losses do not disappear, but are suspended until shareholder basis is sufficiently large to permit the deduction. §§ 1366(d)(1) and 1366(d)(2).

An increased basis resulting from corporate income realized during the year permits the shareholder to take additional corporate deductions or losses (including losses suspended in previous years) on their personal returns, or, alternatively, to receive distributions from the corporation without paying tax. §§ 1366-1368. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 6.06[4] – 6.06[5] (6th ed. 1998).

On their tax returns, the Taxpayers increased their shareholder basis in the PDW&A stock by the amount of their pro rata share of PDW&A's excluded COD income ($1,010,648). This increased basis permitted the Taxpayers to deduct on their personal returns corporate losses and deductions previously allocated to the Taxpayers, but which were suspended under § 1366(d) because the losses exceeded the Taxpayers' basis in their PDW&A stock.

The Commissioner disallowed the deduction of the additional losses, asserting that the shareholder basis increase for excluded COD income was improper under the statutes. The Taxpayers sought redetermination of the Commissioner's proposed deficiencies in the Tax Court.

In the Tax Court, the parties filed cross motions for summary judgment. At oral argument, the Commissioner departed from his contentions on brief. Relying upon Treas. Reg. § 1.61-12(b), the Commissioner argued that

COD income is not an "item of income" within the meaning of §§ 1366 and 1367 because the income is not "realized." Apparently confident that the Tax Court would hold that excluded COD income was not an "item of income," counsel for the Commissioner stated "if the Court finds that excluded COD is an item of income, either tax exempt or otherwise, then we're squarely within Code section 1366, and the basis consequences would flow." (Document No. 20 at p.31).

On June 24, 1997, the Tax Court issued its opinion in *Winn v. Commissioner*, T.C.M. (RIA) 97,286. In that opinion, the Tax Court stated:

> In memoranda filed with the court prior to the hearing on these matters, several arguments were set forth in support of respondent's motions, including the argument that discharge of indebtedness income was 'deferred' and not 'tax exempt income' under § 1366(a) . . . . At the hearing on these matters, however, respondent abandoned those prior arguments and argued the following position:
>
> > If the court were to hold that excluded COD (cancellation (discharge) of indebtedness) is an item of income under § 1366, then you would have to find that it flows through to the taxpayers and they increase their basis. Respondent's position is that it's not an item of income and never flows through. . . .
>
> We deal here solely with respondent's 'final' position.

The Tax Court issued an opinion in favor of the Taxpayers, holding that COD income is an "item of income" within the meaning of § 1366. The Commissioner thereafter filed a motion for reconsideration, arguing that he had not intended to abandon any of the arguments

presented in his memoranda, and that his counsel had merely presented a "new alternative argument." Document No. 24 at p. 2.

The Tax Court granted reconsideration after the issuance of its opinion in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999). *Winn v. Commissioner*, T.C.M. (RIA) 98,071, App. 21. In *Nelson*, the Tax Court held, contrary to the Commissioner's "final position" in *Winn*, that §§ 1366 and 1367 do not control the shareholder stock basis consequences of an S corporation's realization of excluded COD income. Instead, the Tax Court held that § 108 contains a specific provision which overrides the Subchapter S passthrough rules. That provision, § 108(d)(7)(A), requires that certain aspects of § 108 (e.g., determination of insolvency, amount of exclusion, attribute reduction) be "applied at the corporate level" in the case of S corporations.[5] The Tax Court construed the "applied at the corporate level" language to preclude treating excluded COD income as an item of income which is taken into account at the shareholder level pursuant to §§ 1366 and 1367. *Nelson*, 110 T.C. at 121. The Tax Court also concluded that excluded COD income was not "tax-exempt income," which would increase basis under §§ 1366(a)(1)(A) and 1367(a), but was actually "tax deferred income," because the COD income was related to attribute reduction that would result in increased income in the future. *Nelson*, 110 T.C. at 125.

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[5] Section 108(d)(7)(A) provides that, in the case of S corporations, subsections (a), (b), (c), and (g) of § 108 are to be "applied at the corporate level." Section 108(a)(1)(B) provides for an exclusion from income to the extent of insolvency.

The Tenth Circuit specifically rejected the Tax Court's primary holding in *Nelson*, i.e., that the "applied at the corporate level" language of § 108(d)(7)(A) prevented excluded COD income from being taken into account for purposes of §§ 1366 and 1367. *Gitlitz*, 182 F.3d at 1148. However, the Tenth Circuit ruled for the Commissioner on an alternate ground, holding that excluded COD income is eliminated in its entirety at the S corporation level in the process of attribute reduction under § 108(b), prior to the time that the passthrough of excluded COD income would result in a basis increase. *Gitlitz*, 182 F.3d at 1148-1150.

Section 108(b) requires that certain tax attributes be reduced by the amount of COD income excluded under § 108(a). Section 108(d)(7)(B) provides that shareholder losses in excess of basis, suspended under § 1366(d), are treated as a tax attribute subject to reduction. This reduction is supposed to be made "after the determination of tax for the taxable year of the discharge." § 108(b)(4)(A). In this case, if the reduction in shareholder suspended losses were made subsequent to the year of the discharge, the excluded COD income would have been taken into account, and would have increased basis, allowing the passthrough of additional losses in the year of the discharge.

The Tenth Circuit concluded that the issue is one of timing, i.e., whether the amount of excluded COD income is to be applied to reduce suspended losses before it passes through and is taken into account for basis purposes under §§ 1366 and 1367. The Tenth Circuit considered the matter a "close question." It reasoned, however, that an interpretation permitting passthrough prior to attribute reduction would result in a "windfall" to the

Taxpayers. It therefore held that attribute reduction should more appropriately occur in the year of the discharge, not in the subsequent year. The Tenth Circuit concluded that the excluded COD income should be eliminated prior to passthrough by virtue of being "applied against" the Taxpayers' suspended losses. The court also held that income in excess of attributes is disregarded, and does not pass through. *Gitlitz*, 182 F.3d at 1147.

V. SUMMARY OF ARGUMENT

The Taxpayers filed their 1991 tax returns in accordance with the specific and detailed rules set forth in §§ 1366 and 1367. These two provisions, and these two provisions alone, expressly govern the S corporation shareholders' determination of stock basis, which in turn effects the amount of S corporation losses which the shareholder is entitled to claim as a deduction on his or her individual income tax return. These rules state unequivocally that all items of income, including tax-exempt income, increase stock basis, provided that separately taking an item into account could affect any shareholder's tax liability.

The Treasury Regulation interpreting § 1367 is equally clear. It specifically provides that "nontaxable income," i.e., items that are excluded from the S corporation's current year's income and therefore are similarly excluded by the shareholder in determining his or her taxable income, are nonetheless taken into account by the shareholder through an increase in stock basis. Neither §§ 1366 and 1367, nor the regulations interpreting those sections, suggest that excluded COD income is to be treated any differently for shareholder stock basis purposes than any other nontaxable item of income realized

by the S corporation, but excluded from the calculation of taxable income.

Municipal bond interest is excluded from gross income under § 103, but is taken into account by the shareholder and added to his or her stock basis because, in the words of § 1366, the separate treatment of this item "could affect the tax liability of [a] shareholder." The effect that tax-exempt bond interest could have upon shareholder tax liability, since it is not included in the current year's income, is through an increase in shareholder basis. By adding this item to basis, the shareholder is able to deduct additional losses flowing from the S corporation, and potentially eliminate tax resulting from a distribution of assets to the shareholder or a sale of the shareholder's stock. The same potential consequences for shareholder tax liability are present in the case of nontaxable COD income. In addition, excluded COD income could affect each shareholder's tax liability by reducing the shareholder's nondeductible suspended losses, pursuant to the "attribute reduction" provisions of §§ 108(b) and 108(d)(7)(B).

In short, the only sections of the Code that control the determination of shareholder stock basis, §§ 1366 and 1367, are unambiguous. They require that excluded COD income must be taken into account by the shareholder and added to his or her stock basis. Nothing in § 108 provides to the contrary. In fact, § 108 does not mention S corporation shareholder stock basis, let alone provide any special rules for the treatment of excluded S corporation COD income for shareholder stock basis purposes.

Nevertheless, since the Tax Court issued its initial opinion in *Winn*, holding that COD income is an item of income which passes through to the shareholder for stock

basis purposes under §§ 1366 and 1367, the focus of the Tax Court, and then the Tenth Circuit, has been upon § 108, not upon §§ 1366 and 1367. This reflects an effort to avoid the result the Tax Court reached in its initial opinion, where the focus of the court was more properly upon §§ 1366 and 1367. Both courts have in essence rewritten § 108 in an effort to achieve the result which they wanted to obtain.

First, the Tax Court in *Nelson* interpreted § 108(d)(7)(A) and the statutory language providing that the exclusion under § 108 is to "be applied at the corporate level" to mean that COD income cannot be taken into account at the shareholder level. The short answer to that position is that *all* S corporation nontaxable income is initially attributed to the corporation and excluded at the corporate level because it is the corporation that realizes the income, not the shareholder. And, §§ 1366 and 1367 require that all corporate income items be taken into account for purposes of calculating shareholder stock basis. Every appellate court to consider the issue, including the Tenth Circuit in this case, has concluded that the Tax Court's reliance upon § 108(d)(7)(A) was misplaced.

The Tenth Circuit adopted an entirely new rationale urged by the Justice Department. It concluded that § 108(d)(7)(B) required that shareholders' suspended losses be "added to the corporation's net operating losses." Then, before the losses "pass through" to the shareholder, they must be reduced by the amount of excluded COD income as part of the attribute reduction process. The Tenth Circuit held that the attribute reduction process eliminated entirely both the COD income, which the Taxpayers sought to add to their stock basis,

and the additional losses, which the Taxpayers claimed as a result of this increased basis.

The Tenth Circuit's rationale flies in the face of at least two provisions of § 108. First, § 108(d)(7)(B) does not state that shareholder losses in excess of stock basis (before taking into account COD income) are to be treated as corporate net operating losses ("NOLs") and reduced by excluded COD income. Instead, the section says that "any loss or deduction ***which is disallowed for the taxable year of the discharge*** under section 1366(d)(1)" (emphasis supplied) is to be treated as a corporate NOL subject to reduction by the amount of the excluded COD income. Section 1366(d)(1), the provision that limits shareholder loss deductions to shareholder basis, in turn, requires that the calculation of disallowed loss be made only *after* all adjustments to basis under § 1367(a) for the taxable year are computed.

Thus, *before* the attribute reduction can take place, §§ 108(d)(7)(B) and 1366(d)(1) mandate that the shareholder must determine (1) his or her stock basis, and (2) his or her loss, if any, in excess of stock basis. Step (1) requires that a pro rata share of all items of S corporation income for the taxable year, including COD income, be added to shareholder basis. Applying the mandate of the statute to the facts of this case, first, the shareholder basis is increased by excluded COD income. Then, the disallowed net loss for the year is determined. This approach results in a significantly reduced loss "disallowed for the taxable year of the discharge under § 1366(d)(1)" subject to reduction under § 108(d)(7)(B).

Not only did the Tenth Circuit fail to give any operative effect to the express language of § 108(d)(7)(B), but it also essentially wrote § 108(b)(4)(A) out of the Code.

Section 108(b)(4)(A) expressly provides that attribute reduction takes place *after* the determination of tax for the taxable year of the discharge. The Tenth Circuit in essence held that § 108(b)(4)(A) does not mean what it says, and concluded that suspended losses are reduced *during* the taxable year of the discharge, and prior to the pass-through of COD income.

A careful analysis of the three statutes, §§ 108, 1366, and 1367, leads to the reporting position which these and many other taxpayers adopted on their tax returns. The Tenth Circuit concluded that the Taxpayers claimed "the equivalent of a double deduction," in that the Taxpayers did not pay tax on the discharge of debt, and then claimed deductions for suspended losses by reason of a basis increase resulting from the debt relief. In fact, the tax benefits claimed by the Taxpayers do not differ from and are no greater than those afforded by the Code to all other S corporation shareholders whose corporations have nontaxable income and suspended losses: the income is excluded from tax, basis is increased, and the use of otherwise suspended losses is permitted.

Even if the result were considered a "windfall," that does not justify the liberties taken with the controlling statutory language at issue: the Tax Court and the Tenth Circuit both added limitations that do not exist in the Code or the regulations and simply struck operative language from the statutes. The statutes must be interpreted as written, particularly in the absence of any regulation or published ruling stating that the interpretation adopted by the Taxpayers on their returns was incorrect.

Taxpayers already have the difficult task of finding and following the complicated and cumbersome rules of the Code and the Treasury Regulations. Taxpayers should

not have to shoulder the additional risk that, even if they follow those rules to the letter, the tax consequences they claim may be set aside if the Commissioner later decides the consequences were too generous to the taxpayer.

VI. ARGUMENT

A. Excluded COD Income Is An Item Of Income That Increases Shareholder Basis Under §§ 1366 And 1367.

1. Excluded COD Income Is An "Item Of Income."

The primary issue in this case is whether the excluded COD income of an S corporation is taken into account as an item of income by shareholders in their calculation of basis. The statute governing S corporation shareholder basis provides that shareholder stock basis for the S corporation's taxable year is increased by the items of income described in subparagraph (A) of § 1366(a)(1). § 1367(a)(1)(A). Section 1366(a)(1)(A) in turn provides that a shareholder shall take into account the shareholder's pro rata share of the corporation's "items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder."

To resolve the question as to whether or not the excluded COD income of the corporation is properly taken into account by the shareholder, it is necessary to determine whether excluded COD income is an "item of income" for purposes of § 1366(a)(1)(A). That question was correctly resolved by the Tax Court in its first *Winn* opinion, where the Court stated:

> Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, section 61(a)(12) requires that discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Sec. 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items so excluded. Sec. 108(a)(1)(A), (3).
>
> Based upon the foregoing, we hold that discharge of indebtedness is an "item of income" for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under section 61(a)(12).

Winn v. Commissioner, T.C.M. (RIA), 97,286, *withdrawn and reissued as* T.C.M. (RIA) 98,071. Although the *Winn* opinion was withdrawn, neither the reissued *Winn* opinion, nor the *Nelson* opinion, disputed that excluded COD income was an "item of income," but reasoned that the item remained at the corporate level, and was not passed through. Every Circuit to examine the issue has likewise considered excluded COD income as an "item of income." *United States v. Farley*, 202 F.3d 198, 209-210 (3d Cir. 2000); *Pugh v. Commissioner*, 2000 WL 718215 at *5 (11th Cir. 2000); *Witzel v. Commissioner*, 200 F.3d 496, 498 (7th Cir. 2000); and *Gaudiano v. Commissioner*, 2000 WL 748179 at *10 (6th Cir. 2000); *See also Hogue v. United States*, 2000 WL 2651 at *2, 85 A.F.T.R.2d 2000-426 (D.Ore. 2000),

The exclusion of COD income from gross income does not prevent its inclusion as a corporate "item of income" which increases shareholder basis. Congress

made this principle clear when it specifically referred to "tax-exempt income" as being included within the broad reach of corporate "items of income" that effect basis under §§ 1366 and 1367. Congress, moreover, did not limit the items to be added to shareholder basis to those that were "taxable" or "tax-exempt." Instead, it required each and every item realized by the S corporation to be added to shareholder basis, provided the item could affect the tax liability of any shareholder.

2. Excluded COD Income "Could Affect" Shareholder Tax Liability Through Basis Adjustments Or Attribute Reduction.

The language "could affect the liability for tax of any shareholder" has a more sweeping reach than "increases or decreases the gross income" of any shareholder. Certainly items of income that are both realized *and* recognized by the corporation directly increase the shareholder's taxable income and consequentially effect his or her tax liability. However, a potential impact upon an individual shareholder's tax liability is also present with "items of income" which are realized but not recognized by the corporation.

Nontaxable income such as state and local bond interest under § 103 and life insurance proceeds under § 101 does not *directly* alter any shareholder's tax liability by increasing his or her gross income. Income treated as nontaxable at the corporate level will not be treated otherwise at the shareholder level. § 1366(b). Thus, the meaning of the phrase "could affect the tax liability of any shareholder," when referring to nontaxable income, necessarily relates to an indirect consequence of having realized the income. One such indirect consequence is the

effect that an asset distribution has upon the tax liability of the receiving shareholder. Congress specifically recognized that a basis increase is necessary in order to protect the nontaxable item from taxation at the shareholder level.[6] *See* S. Rep. No. 640, 97 Cong., 2nd Sess. 16 (1982), 1982-2 C.B. 718, 725; *Pugh*, 2000 WL 718215 at *4. In addition, a basis increase for nontaxable income such as municipal bond interest allows a shareholder to deduct his or her share of S corporation losses suspended under § 1366(d) to the extent of the increase.

The aforementioned indirect consequences of taking the income into account are likewise present with respect to excluded COD income. Moreover, another, equally compelling effect exists as well. Under § 1366(d), where a shareholder's share of S corporation losses and deductions for any taxable year exceeds his or her stock basis, the excess may not be deducted currently, but is "suspended" and carried to future periods for deduction by the shareholder if and when the shareholder obtains sufficient basis. §§ 1366(d)(1) and 1366(d)(2). Section 108(d)(7)(B) provides that, in the case of an S corporation, one of the "tax attributes" subject to reduction under § 108(b) is the aggregate of § 1366(d) suspended losses which the corporation's shareholders possess.

Mechanically, § 108(d)(7)(B) accomplishes this result by providing that shareholder suspended losses are to be treated as if they were net operating losses ("NOLs") for

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[6] A distribution of assets by an S corporation to its shareholder is normally nontaxable to the shareholder to the extent of his or her basis. § 1368. Likewise, the amount of the shareholder's basis potentially affects the amount of gain or loss on the sale of his or her stock. JACOB MERTENS, 11 LAW OF FED. INCOME TAXATION, § 41B:154.

purposes of § 108(b) attribute reduction. NOLs are the first item reduced under § 108(b)(2). Thus, attribute reduction may diminish shareholder-level suspended losses, and ultimately affect the shareholders' tax liability in future years.

As an illustration of how the receipt of COD income may be related to shareholder tax liability, suppose that an S corporation has two shareholders: A, with a stock ownership of 60%, and B, with 40%. A and B each have losses suspended under § 1366(d)(1) in the amounts of $90 and $40, respectively, as of the time of attribute reduction. *See* § 108(b)(4). Assume that the corporation realizes $30 in excluded COD income. It is necessary to reduce the shareholder suspended losses in accordance with the shareholders' pro rata share of the income item when attribute reduction takes place under §§ 108(b)(2)(A) and 108(d)(7)(B). Any other allocation would be arbitrary and unfair. In this illustration, A's suspended losses are reduced by $18 (60% of $30) to $72 and B's suspended losses are reduced by $12 (40% of $30) to $28.

Therefore, it cannot be seriously disputed that excluded COD income "may affect" the tax liability of a shareholder. A potential consequence of the realization of excluded COD is the reduction of shareholder-level suspended losses. This reduction may ultimately result in an increase in the shareholders' tax in subsequent years. As such, excluded COD income must be taken into account by shareholders in the calculation of their stock basis under § 1367(a)(1)(A).

3. The Treasury Regulation Interpreting § 1367 Requires That Nontaxable Income Be Added To Shareholder Basis.

The Treasury Regulations,[7] consistent with the statutes, do not condition a basis increase upon an item being either "taxable" or "tax-exempt." The relevant Treasury Regulation[8] provides that the inclusion of an item of

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[7] The regulations discussed herein are those portions of §§ 1.1367-1 through 1.1367-3 which were finalized in 1994. In 1998 after the *Nelson* opinion was issued by the Tax Court, Treasury released new proposed regulations that made substantial changes to the treatment of COD income under §§ 1366, 1367, and 1368. *See* New § 1.1366-1(a)(2)(viii); 63 Fed. Reg. 44,181-01. These regulations were ultimately finalized in December of 1999. 67 Fed. Reg. 71,641. The new regulations by their terms are effective only for tax years beginning after August 18, 1998. § 1.1366-5.

[8] The regulations under § 1367 discussed herein were first published in proposed form on June 9, 1992 (57 Fed. Reg. 24,426, PS-264-82, 1992-2 C.B. 760), prior to the extended due dates of the Taxpayers' income tax returns. Treasury adopted substantially identical regulations thereafter. 59 Fed. Reg. 12, T.D. 8508, 1994-1 C.B. 219. The Tax Court ignored these regulations (§§ 1.1367-1 through 1.1367-3) in its *Nelson* opinion, stating that no regulations were in effect during the year at issue (1991). *Nelson*, 110 T.C. at 118. While technically correct, the Tax Court's analysis is incomplete. Although these regulations were only directly applicable to tax years after 1993, with respect to pre-1994 years, § 1.1367-3 provides that taxpayer positions must be reasonable, and that taxpayer positions in accordance with the regulations would be treated as reasonable. By essentially renouncing the right to challenge taxpayer positions taken in accordance with the regulations in years prior to the effective date of the regulations, as a practical matter, the Commissioner gave the regulations retroactive effect, at least as a safe harbor. Moreover, Treasury's interpretation of the statute proposed initially in 1992 and well prior to any litigation regarding the

nontaxable income in the shareholder basis computations for the taxable year depends upon whether the item would have been included in income during the year had it been taxable, rather than nontaxable:

> [A basis] adjustment for a ***nontaxable item*** is determined for the taxable year in which the item would have been includable or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Treas. Reg. § 1.1367-1(d)(2) (Emphasis supplied.). If the COD income "had been subject to federal income taxation," it would be includable ***only*** in the year of discharge. Under no circumstances would recognition of ***taxable*** COD income be deferred beyond the year of discharge under the corporation's method of accounting.

Nevertheless, the Commissioner has argued that COD income is only "tax-deferred," not "tax-exempt," and therefore is not an item that increases basis under §§ 1366 and 1367.[9] While we dispute that characterization as discussed in Section E of the Argument, the rule for determining whether an item is taken into account or "deferred" for purposes of shareholder basis is clearly set out in Treas. Reg. § 1.1367-1(d)(2). Any argument for deferral must be consistent with the language of that regulation.

The Commissioner's suggestion that excluded COD items which are "nontaxable" in the current taxable year,

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issue involved in this case, stands as persuasive authority as to how the statute should be interpreted.

[9] The Commissioner's argument has been accepted only by the Tax Court in *Nelson*, and not by any of the Circuit Courts to review this issue.

but which might be related to collateral tax consequences in future years, should be treated as a "deferred item," cannot be reconciled with the language of the regulation. This is because the item itself (COD income) is not deferred. The excluded discharge of indebtedness is indisputably realized and would have been "includable [in gross income in the year of receipt] . . . for federal income tax purposes under the corporation's method of accounting" had it been a taxable debt discharge under § 61(a)(12). The COD income item (*qua* item) will never be taken into account in any future year.[10]

The conflict between the Commissioner's postulated "tax deferred" characterization and language of the governing regulation is striking: the regulations require inclusion of ***all*** items, even those that are "nontaxable," if the corporation's method of accounting places the item in the current year.[11] The plain and unqualified language of

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[10] With respect to decreases in stock basis for losses or deductions, in its 1992 transmittal of the proposed regulations that would ultimately be adopted in 1994, Treasury explained that the timing of the basis decrease depended solely upon "the amount of any loss or deduction that is allowed for the taxable year under section 1366(d), regardless of whether the loss or deduction is disallowed or deferred under another provision of the Code, such as the passive loss rules of section 469." 57 Fed. Reg. 24,426, 24,427-24,428. Thus, so long as the placement of the deduction in the current year is correct under § 1366, the fact that certain tax consequences of the deduction are postponed until subsequent years is irrelevant. The same rule should apply for items of income as apply to items of loss or deduction.

[11] When the corporation's method of accounting places an item (or portions thereof) in different taxable years, deferral is appropriate. *See Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 504-506 (1948) (items recognized on the installment method need not be included in C corporation earnings and profits – the

Treas. Reg. § 1.1367-1(d)(2) makes the determination of whether an income item effects basis depend solely upon whether the item would have been includable in gross income under the corporation's method of accounting had the item "been subject to federal income taxation." The Commissioner cannot plausibly claim that the COD income item is more appropriately taken into account in any year other than the year of the discharge.

4. The Legislative History Confirms That Basis Should Be Increased By All "Non-Taxable" Items.

The legislative history of the Subchapter S Revision Act of 1982 uses the term "non-taxable income" in describing the types of income items that will serve to increase basis:

> Under the bill, both taxable and ***non-taxable income*** and deductible and non-deductible expenses ***will serve,*** respectively, ***to increase*** and decrease a Subchapter S ***shareholder's basis*** in the stock of the corporation.

S. Rep. No. 640, 97th Cong., 2d Sess. 18 (1982), 1982-2 C.B. 718, 726 (emphasis supplied). The language of the legislative history, like the regulations, describes a tax world comprised of only "taxable" and "non-taxable" income. Expenses similarly are either "deductible" or "non-deductible." The language of the legislative history recognizes no in-between. There does not exist a "tax limbo" where the government can conveniently hide income

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computation of which is similar to that of shareholder basis in Subchapter S stock – until payments are includable under the corporation's method of accounting).

items that unfortunately conflict with ill-reasoned theories. Congress understood that ***each and every*** item of income, if properly realized in a given year, would increase basis, whether taxable or non-taxable.

Thus, the statute, the regulations, and the legislative history all consistently and without equivocation describe a tax system where COD income realized and properly taken into account by an S corporation in a given year, whether taxable or nontaxable, serves to increase basis. The benefit claimed by the Taxpayers in this case, i.e., an increase to shareholder basis that permits the use of formerly suspended losses, is squarely within the language of the statutes and the Treasury Regulations.

B. The Commissioner And The Courts Have Denied The Taxpayers The Statutory Basis Increase Under A Variety Of Legal Theories.

Notwithstanding the clear language of the statutes, the Commissioner challenged the basis increase taken by the Taxpayers on the grounds that excluded COD income should not pass through to Subchapter S shareholders. The Commissioner's position was first articulated in a 1994 technical advice memorandum. Tech. Adv. Mem. 94-23-003 (June 10, 1994) (the "TAM"). Virtually all of the commentators disagreed with the analysis in the TAM and concluded that the Commissioner's position was without merit.[12] Recognizing the legal and logical flaws

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[12] *See, e.g.*, AICPA, *Pre-Release Comments Regarding Regulations on Discharge of Indebtedness Income under Internal Revenue Code Section 1366*, Apr. 5, 1995 (Reprinted in the BNA DAILY TAX REPORT, April 10, 1995 at G-2); Richard M. Lipton, *IRS Challenges S Corporation Basis Increase for COD Income*, 81 J.TAX'N

in the Commissioner's arguments, these commentators reasoned that the statutory provisions at issue were clear and unambiguous, and that the IRS must seek an amendment to the Code if it wished to alter the results. The Commissioner chose neither to pursue corrective legislation, nor to clarify his position by releasing Treasury Regulations or other published guidance, prior to pursuing a judicial solution.

The Tax Court agreed with the Commissioner that excluded COD income realized by an S corporation cannot be passed through to the shareholders and used to increase the basis in their stock when it issued its opinion in *Nelson*. The Tax Court based its decision on a provision outside Subchapter S, § 108(d)(7)(A). This statute provides that certain subsections of § 108, including the basic exclusion from income of § 108(a), are to be applied "at the corporate level." The Tax Court interpreted this language to override and create an exception to the pass-through rules of §§ 1366 and 1367, and consequently held that excluded COD income was solely a corporate level item that could not be passed through and taken into

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340 (Dec. 1994); Richard M. Lipton, *The Story of the Tortoise and the Hare: Workouts Involving S Corporations*, TAXES, April 1994, p. 163; Richard Gore, *Troubled 'S' Corporation That Recognizes COD Income May Yield Substantial Tax Benefits*, 9 TAX MGMT. REAL EST. J. 80 (Apr. 7, 1993); Brian P. Collins and Mark A. Schneider, *TAM 9423003: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis*, 6 J. OF S CORP. TAX'N. 348; *See also* James S. Eustice, *Financially Distressed S Corporations*, 53 TAX NOTES 97 (1991) (issue first articulated); Fred T. Witt, Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Task Force*, 46 TAX LAW. 209, 234-35 (Prior to issuance of TAM, blue ribbon Task Force concludes applicable law is clear, but a minority suggests that a legislative change should be pursued by the IRS.)

account at the individual level. *Nelson*, 110 T.C. at 121-122.

Commentators were just as critical of this Tax Court holding as they were of the original TAM.[13] The Tenth Circuit in *Gitlitz* likewise found the Tax Court's interpretation of § 108(d)(7)(A) unpersuasive:

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation.

Gitlitz, 182 F.3d at 1148. The Tenth Circuit held that such income would pass through to shareholders unless it was absorbed in the attribute reduction process implemented under § 108(b). *Gitlitz*, 182 F.3d at 1148. The Tenth Circuit also held that any excluded COD income not absorbed would be disregarded. *Gitlitz*, 182 F.3d at 1151.

The Third Circuit in *Farley*, 202 F.3d at 209-210, the Eleventh Circuit in *Pugh*, 2000 WL 718215 at *5, the Seventh Circuit in *Witzel*, 200 F.3d at 498, and the Sixth Circuit in *Gaudiano*, 2000 WL 748179 at *10, like *Gitlitz*, rejected the Tax Court's interpretation of § 108(d)(7)(A),

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[13] *See* Jerry S. Williford, *Shareholder is Wrestled Down with a Full Nelson – Interplay of COD and S Corporation Rules*, TAX MANAGEMENT MEMORANDUM (August 3, 1998); Richard M. Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. TAX'N 272 (May 1998); James D. Lockhart and James E. Duffy, *Tax Court Rules in Nelson that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis*, 25 WM. MITCHELL L. REV. 287 (1999).

and reasoned that excluded COD income constituted an "item of income" for purposes of the § 1366 passthrough and the § 1367 adjustment to basis rules. The *Farley* court, as well as the Oregon district court in *Hogue*, held for the taxpayers, rejecting the *Gitlitz* absorption model as contrary to the statutory scheme. *Farley*, 202 F.3d at 205-206, *Hogue*, 2000 WL 2651 at *3. The *Witzel* and *Gaudiano* courts held for the Commissioner on grounds similar to those set out by the Tenth Circuit in *Gitlitz*, i.e., COD income is absorbed in the attribute reduction process, but reasoned that any income not absorbed should not be disregarded, and would serve to increase basis. *Witzel*, 200 F.3d at 498; *Gaudiano*, 2000 WL 748179 at *10. The *Pugh* court did not have to address the *Gitlitz* absorption rationale, because the taxpayers before it had no attributes, but it did agree with the *Farley* court (and the dicta in *Witzel* and *Gaudiano*) that excluded COD income in excess of attributes is added to basis. *Pugh*, 2000 WL 718215 at *5 n.13.

C. The Tax Court Holding That § 108(d)(7)(A) Created A Special Exception To The General Passthrough Rules Of §§ 1366 And 1367 Is Incorrect.

1. The *Nelson* Court Misinterpreted The Phrase "Applied At The Corporate Level."

In reaching its conclusion, the *Nelson* court overlooked the fundamental rules of Subchapter S that govern the relationship between corporation and shareholder. All items of income and deduction related to activities of the corporation are attributed in the first instance to the corporation, not its shareholders, and the taxable income of an S corporation as an entity is "computed in the same manner as in the case of an individual." § 1363(b). Under

this system, "deductions generally allowable to individuals [are] allowed to subchapter S corporations." S. Rep. No. 640, *supra* at 15, 1982-2 C.B. at 724. Thus, the question as to what extent deductions are "allowable" is ***always*** answered initially at the corporate level. Likewise, income realized by an S corporation is recognized and included in the corporation's taxable income, or is excluded from gross income (if a specific statutory exclusion is implicated) "at the corporate level."

The Tax Court ignored the settled meaning of the phrase "applied at the corporate level." The phrase "applied at the corporate level" has been used in other circumstances by Treasury in connection with S corporations. For example, the hobby loss limitations under § 183 are "applied at the corporate level" in the case of an S corporation. Treas. Reg. § 1.183-1(f). *See also Sousa v. Commissioner*, T.C.M. (RIA) 89,581. The application of the hobby loss limitations at the corporate level does not alter or prevent the S corporation from passing through the ***allowable*** portion of such deduction to the shareholder.[14] The accepted meaning of the phrase is that certain limitations are applied and/or results determined first at the "corporate level" *before* such items are subsequently

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[14] Likewise, the statute governing S corporation audit procedures (former § 6241) during the year at issue provided that the "tax treatment of any subchapter S item shall be **determined at the corporate level**." (emphasis supplied.) Former § 6241 (1995), repealed by P.L. 104-188, § 1307(c)(3)(C). The corporate level adjustments are then passed through as adjustments to the shareholders' individual tax liabilities. *See Twenty-three Nineteen Creekside, Inc. v. Commissioner*, 59 F.3d 130, 133 (9th Cir. 1995) ("Congress provided tax determinations for S corporations would take place at the corporate level, except where the Secretary provided otherwise by regulations.")

passed through and taken into account at the shareholder level.

Since Congress chose to use a phrase ("applied at the corporate level") in § 108(d)(7)(A) that has been used in connection with other S corporation rules and which has a commonly understood meaning in the taxation of S corporations and their shareholders, the interpretation of the phrase in § 108(d)(7)(A) must be consistent with the meaning accorded to the phrase in its other uses. *Commissioner v. Keystone Consol. Industries, Inc.*, 508 U.S. 152, 159 (1993).

2. There Is No Indication That Congress Intended To Create An Exception To The Subchapter S Passthrough Rules When It Enacted § 108(d)(7)(A).

Under the statutory scheme existing prior to the enactment of § 108(d)(7)(A), the determination as to whether an item of COD income was excludable, i.e., the amount of insolvency, was required to be made with respect to each shareholder of the S corporation. P.L. 97-354, § 3(e), amending § 108(d)(6). Section 108(d)(7)(A) changed that rule and applied the insolvency determination "at the corporate level." However, the statutes governing S corporation basis calculation were not changed with the enactment of § 108(d)(7)(A). Nothing in the statutory language or the legislative history pertaining to § 108(d)(7)(A) even hints that Congress intended to alter the rule that all income passes through to shareholders.

The *Nelson* court read § 108(d)(7)(A) as an adjustment or exception to the general S corporation rules embodied in §§ 1366 and 1367, which require the pass through of all income "realized or recognized at the corporate level" by

an S corporation. *Nelson*, 110 T.C. at 120-121. However, if Congress amended the working of §§ 1366 and 1367 through its enactment of § 108(d)(7)(A), it did so solely by implication because the "passthrough rules" were never mentioned in either the statute or legislative history of § 108(d)(7)(A).

The general rule of statutory construction is that "amendments by implication" are disfavored. *United States v. Welden*, 377 U.S. 95, 102 n.12 (1964). When later statutes do not directly address the workings of earlier statutes, the finding of an amendment by implication can only be based on the legislature's clear and manifest intention. *City of Tulsa, Oklahoma v. Midland Valley R. Co.*, 168 F.2d 252, 254 (10th Cir. 1948).

The literal language of § 108(d)(7)(A) does not conflict at all with the provisions of Subchapter S. *Farley*, 202 F.3d at 208-209. Moreover, the lack of any direct reference to shareholder basis adjustments in § 108(d)(7)(A) evidences an ***absence*** of any intention to modify the previously existing S corporation stock basis rules, particularly when one considers the explicit statements regarding shareholder basis adjustments contained in the contemporaneously enacted § 108(d)(7)(C), which addresses adjustments to basis in shareholder loans required in connection with contributions of shareholder indebtedness.

D. The Tenth Circuit's Holding That Discharge Of Indebtedness Income Does Not Pass Through Because It Is Offset By Attribute Reduction Is Contrary To The Plain Language Of The Statutes.

In *Gitlitz*, the Tenth Circuit concluded that an S corporation's COD income does not pass through to shareholders and increase their stock basis because the income is eliminated at the S corporation level where it is "applied against" shareholder suspended losses, which are treated as a "tax attribute" and subject to reduction under § 108(b).

Section 108(b)(1) provides that "the amount [of COD income] excluded from gross income . . . shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." The "tax attributes" potentially subject to reduction under § 108(b)(2) include NOLs for the current year and NOL carryovers from other years, capital loss carryforwards, and basis in property. *See* § 108(b)(2)(A)-(G). In the case of S corporations, which do not have NOLs or NOL carryovers because their annual losses flow through to the shareholder in their entirety (*See* § 1371(b) and Treas. Reg. § 1.172-1(f)), there is a special rule which requires that losses previously allocated to the S corporation's individual shareholders, but suspended because of insufficient shareholder basis under § 1366(d)(1), are to be treated as NOLs for attribute reduction purposes. § 108(d)(7)(B). Shareholder suspended losses under § 1366(d)(1) are the amount by which losses flowing through to the shareholder exceed stock basis. This amount is nondeductible for the current year, but carries forward and can be used as a deduction in subsequent years to the extent that stock basis is

increased. § 1366(d)(2). The rule of § 108(d)(7)(B) operates to reduce shareholder suspended losses in the same manner as C corporation NOLs are reduced.

The Tenth Circuit concluded that the case turned on the timing of the § 108(b) attribute reduction. The Tenth Circuit considered the timing issue "the most difficult aspect of this case," and acknowledged that, if corporate attributes were reduced after the taxable year of the discharge, "the taxpayers' theory must prevail." *Gitlitz*, 182 F.3d at 1148. The Tenth Circuit interpreted the timing statute, § 108(b)(4)(A), to provide for attribute reduction *during*, rather than *after*, the taxable year of discharge, and prior to the required passthrough of all items of S corporation income. However, in order to reach this result, the Tenth Circuit disregarded:

(1) The rules of §§ 108(d)(7)(B) and 1366(d)(1), which require that all items of S corporation income for the year be taken into account at the shareholder level for basis purposes before the amount of the "suspended loss" attribute can be determined; and

(2) The plain language of the statute, which requires that attribute reduction "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." § 108(b)(4)(A).

1. The Tenth Circuit Disregarded The Language Of §§ 108(d)(7)(B) And 1366(d)(1) When It Concluded That Suspended Losses Become Corporate Net Operating Losses Subject To Attribute Reduction Before Excluded COD Income Is Passed Through And Taken Into Account By Shareholders In The Determination Of Their Tax Liability.

In adopting an "absorption" rationale, the Tenth Circuit put the cart before the horse. The "horse," shareholder suspended losses, are an attribute that can only come into existence and be computed *after* the shareholder's basis for the taxable year has been determined under the rules of §§ 1366 and 1367. The "cart," attribute reduction, only comes into play to the extent that shareholder losses exceed basis *after* the excluded COD income item has been added to basis. Sections 108(d)(7)(B) and 1366(d)(1), taken together, leave no room for any other interpretation.

In explaining how it understood COD income to be "absorbed" in the attribute reduction process, the *Gitlitz* court stated that the corporation "first must compute its discharge of indebtedness income and set this figure aside temporarily."[15] *Gitlitz*, 182 F.3d at 1151. Then, the court reasoned that § 108(d)(7)(B) requires that shareholder suspended losses "be added to the corporation's annual net operating losses in applying the net operating loss attribute reduction." *Gitlitz*, 182 F.3d at 1148. The court concluded that this means that before shareholders

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[15] The statutory basis for "temporarily setting aside" COD income until attribute reduction occurs was never explained by either the Commissioner or the Tenth Circuit.

compute their stock basis, (1) the corporation must compute its NOL attribute, which equals the suspended losses of the shareholders from prior years, plus the current year's loss, and (2) the corporation must then apply the COD income against the shareholder suspended losses, eliminating the COD income for passthrough purposes. *Gitlitz*, 182 F.3d at 1151.[16]

The Tenth Circuit failed to recognize that the computation of suspended losses presupposes and requires the passthrough of excluded COD income. In this regard, § 108(d)(7)(B) treats "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1)," as an attribute subject to reduction under § 108(b). Thus, the taxpayer must first make a determination as to how much loss or deduction is "disallowed" for the taxable year, pursuant to § 1366(d)(1). Section 1366(d)(1), in turn, provides that the disallowed amount is calculated with reference to the shareholders' adjusted basis in their stock "determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year."

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[16] The Tenth Circuit appears to believe that the language of § 108(b)(1), providing that "the amount excluded . . . shall be applied to reduce the tax attributes" meant that the excluded COD income itself was eliminated. This is incorrect: the ***amount*** of the excluded income is just used as the measurement for the amount of attribute reduction. This is a common method for making correlative adjustments under the Code. For example, § 50(c) provides "if [investment] credit is determined . . . , the basis of [investment credit] property shall be reduced by the amount of the credit. . . . " The investment credit itself does not disappear because the amount of the credit is used to reduce basis in the investment credit property.

Therefore, in order to determine the net suspended loss for the year under § 1366(d)(1), shareholders must first calculate their stock basis under § 1367(a)(1), taking into account *all items* of income for the year (including COD income), and then compare this basis amount with all items of loss or deduction (which include previously suspended losses from prior years under § 1366(d)(2)). It is only to the extent that the losses and deductions exceed basis that the shareholder will have a net suspended loss for the year under § 1366(d)(1). Analytically, the calculation of basis under § 1367 is a preliminary computation that must be made logically prior to the determination of the suspended loss for the year under § 1366(d)(1). Only the amount of suspended loss that exceeds the shareholder's basis, which includes the shareholder's pro rata share of ***all*** corporate income for the year, is actually "disallowed for the taxable year of the discharge" under § 1366(d)(1) and, therefore, subject to attribute reduction. The statutory scheme does not permit one to "temporarily set aside" COD income at the corporate level and then calculate suspended losses for the year. Excluded COD income must be taken into account in computing the disallowed losses at the shareholder level under §§ 108(d)(7)(B) and 1366(d)(1).[17]

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[17] An additional problem exists with the Tenth Circuit's analysis that attribute reduction occurs prior to the passthrough of income. The rationale eliminates losses that the corporation's non-COD passthrough income would have allowed. Suppose that a corporation whose shareholders possess $100 in suspended losses receives $100 of ordinary income and $100 of excluded COD income during the year. If attribute reduction occurs before the passthrough of income, the $100 in suspended losses is eliminated, and cannot be used by the shareholders to offset the $100 in ordinary income, because the passthrough of

The Tenth Circuit's application of § 108 to the facts of this case vividly illustrates the flaws in the court's analysis. The court acknowledged that in 1991 the S corporation had approximately $2 million in excluded COD income. Gitlitz and Winn each had more than $1 million in losses, including losses suspended in prior years and losses incurred in 1991. The Tenth Circuit reasoned that the process first required the computation of the NOL attribute subject to reduction, which the court stated equaled the $2 million in losses. But §§ 108(d)(7)(B) and 1366(d)(1) only treats the net loss disallowed for 1991 calculated *after* the adjustments to basis required under §§ 1366 and 1367 as a corporate NOL, subject to attribute reduction. When adjustments to basis were properly made under §§ 1366 and 1367, Gitlitz and Winn each had an additional $1 million in COD income added to basis, against which their losses of $1 million were applied, significantly reducing the net suspended loss for the year which would be available for attribute reduction.

The Taxpayers emphasize that their interpretation of § 108(d)(7)(B) does not preclude suspended losses from ever being reduced as a tax attribute; any losses that are not used after the basis increase for corporate income for the year, and which remain suspended under § 1366(d)(1), are subject to reduction. If Gitlitz and Winn each had $2 million in suspended losses, $1 million of

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both types of income must occur simultaneously. If the S corporation had not realized excluded COD income, the shareholder's suspended losses would have been available to offset the ordinary taxable income. This inequitable result penalizes shareholders simply because the corporation received excluded COD income. Congress could not have intended this result.

suspended loss would have been disallowed as a deduction for each Taxpayer under § 1366(d)(1) and then eliminated through attribute reduction under §§ 108(d)(7)(B) and 108(b).[18] Moreover, attribute reduction is not limited to shareholder losses, and may also include the corporation's basis in property as well under §§ 108(b)(2)(E) and 1017.

2. The *Gitlitz* Court Misread The Plain Language Of § 108(b)(4)(A) To Require Attribute Reduction In The Current Year.

Section 108(b)(4)(A) provides that the tax attribute reduction required by § 108(b)(2) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." This means tax attributes can be fully used to reduce tax liability for the year of the discharge. For example, a NOL carried over from the prior year may be used to reduce tax liability in the year of the discharge in an amount unreduced by COD income. It is the NOL, if any, left over *after* the tax computation for the year of the discharge that is subject to reduction. The statute similarly entitles taxpayers to use shareholder losses in the year of discharge. Those losses that are not allowed in the year of discharge are subject to reduction as of the beginning of the following year.

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[18] The Sixth Circuit in *Gaudiano* was persuaded by the Commissioner that, if attribute reduction occurred in the subsequent year, there would be no income remaining at the corporate level to apply against tax attributes. *Gaudiano*, 2000 WL 748179 at *10. This analysis is incorrect. Section 108(d)(7)(B) provides that disallowed losses under § 1366(d)(1) and/or other attributes must be reduced, irrespective of whether excluded COD income passes through to shareholders.

The Third Circuit in *Farley* concurred with the Tenth Circuit's conclusion that the timing rule of § 108(b)(4)(A) was dispositive of the case. *Farley*, 202 F.3d at 205-206. The *Farley* court, however, held that the plain language of the statute mandated a different result:

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by

> section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, 202 F.3d at 205-206.[19] *See also Pugh*, 2000 WL 718215 at *5-6.

Congress understood that attribute reduction was to be postponed until after the full computation of the current year's tax liability. The Senate Report explained that § 108(b) provides that both the current year's loss and any NOL carryover to that year are potentially subject to reduction by excluded COD income, but added that "[t]hese reductions are made after the computation of the current year's tax period." S. Rep. No. 1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 626 n.13. Congress unquestionably intended taxpayers to have the use of NOLs during the year of the discharge, with the proviso that any amount unused would be subject to reduction.

Congress's intention that attribute reduction occur in the subsequent taxable year is confirmed by its enactment in 1980 of § 1017, contemporaneous with the enactment of § 108(b)(4)(A). Section 1017 is another part of the insolvency taxation regime. This section governs attribute reduction with respect to basis in assets, one of the other "tax attributes" listed in § 108(b)(2). Prior to its amendment in 1980, § 1017 required that a taxpayer reduce his

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[19] The Seventh Circuit in *Witzel* reached its conclusion that COD income was offset by attribute reduction in the year of discharge, without explicit consideration of the § 108(b)(4)(A) timing rule. *Witzel*, 200 F.3d at 497. The Sixth Circuit in *Gaudiano* concluded that the *Gitlitz* court had correctly decided the timing rule. *Gaudiano*, 2000 WL 748179, at *10.

or her basis in assets by the amount of excluded COD income *during* the taxable year of the discharge.[20] As part of the Bankruptcy Tax Act and simultaneous with the addition of § 108(b)(4), § 1017(a) was amended to provide that if a reduction in property basis is required as part of attribute reduction, the reduction "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year *following* the taxable year in which the discharge occurs." (Emphasis supplied.) Under § 1017, when a taxpayer sells an asset with a $100 basis during the year of discharge for $100, and also has $100 COD income, the asset basis will not be reduced by the COD income and the taxpayer will report no gain on the sale. However, if the taxpayer instead sold the asset in the year after the discharge, and the property's basis was reduced in attribute reduction, the taxpayer's basis would have been lower at the time of sale, producing gain recognition and tax liability in that year.[21]

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[20] Prior to amendment in 1980, § 108 provided a much more limited exclusion for COD income, specifically conditioned upon the taxpayer's affirmative election to reduce his basis in accordance with § 1017. § 108 (1979), amended by 94 Stat. 3389 (1980). The pre-1980 version of § 1017 stated that where COD income was excluded under § 108, the taxpayer's basis in property owned at the beginning of or at any time during the taxable year of the discharge would be reduced "as of the first day of the taxable year in which the discharge occurred." § 1017 (1979), amended by 94 Stat. 3389 (1980).

[21] Section 108(b)(5) allows taxpayers to elect to have reduction in asset basis under §§ 108(b)(2)(E) and 1017 occur in lieu of other attribute reduction. Under § 1017, such reduction takes place the first day of the following year. The Tenth Circuit's reasoning, which requires attribute reduction in the year of discharge ("absorbing" COD income in the reduction of tax attributes), allows taxpayers who have both corporate basis

The Tenth Circuit's holding in *Gitlitz* denies the shareholder with excluded COD income and suspended losses equal treatment with the shareholder who has excluded COD income and whose corporation has basis in assets. The latter can have his corporation sell assets in the year of the discharge and obtain the benefit of a lower gain passthrough (because of the higher basis) in his computation of tax, but the former cannot obtain any benefit from her suspended losses, even in the year of the discharge.

Congress clearly intended that the attribute reduction rules under §§ 108(b)(4)(A) and 1017 be consistent. The *Gitlitz* opinion artificially and inappropriately frustrates Congress's intent by bifurcating attribute reduction into two separate years: the year of the discharge for most attributes and the following year for basis in assets. This is a perverse and indefensible result.

In an attempt to explain what the language "after the determination of tax for the taxable year" meant, if it did not include basis computations, the Tenth Circuit, citing no authority, held that the "determination of tax" referenced in § 108(b)(4)(A) was limited to "certain tax applications," such as the computation of charitable

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in assets and suspended losses to elect, under § 108(b)(5), to have some or all of the attribute reduction (basis in property) occur in a different year from the §§ 1366 and 1367 passthrough. This would mean that, where taxpayers made the § 108(b)(5) election, excluded COD income would be added to stock basis in the year of the discharge and would not be "absorbed" in the attribute reduction process, because attribute reduction with respect to basis in property would not occur until the following year. Such electing taxpayers would be allowed a basis increase and be permitted to make use of suspended losses during the year of the discharge, unlike their non-electing counterparts.

contribution amounts. This interpretation cannot be reconciled with the language of the statutes.

Section 108(b)(4)(A) cannot be interpreted as requiring initial computations that are part and parcel of the calculation of tax liability for the year be made by taking tax attributes into account, while at the same time, requiring final computation to be made without them.[22] The statute provides no hint that such a result was intended by Congress. Nor is there any principled way of differentiating those computations that include tax attributes from those that do not.

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[22] For example, under § 170, an individual's charitable contribution deduction is limited to a percentage of adjusted gross income (AGI). § 170(b)(1)(F). AGI, however, includes NOL carryforwards from prior years. Consider the situation where a taxpayer with an NOL carryforward of $100 realized $100 of excluded COD income during the taxable year, and also made a charitable contribution during that year. The taxpayer must compute his or her AGI for purposes of determining the allowable charitable contribution amount. Using the *Gitlitz* court's interpretation of § 108(b)(4)(A), the taxpayer must first include the NOL carryforward because COD income would not be applied to "eliminate" the NOL for purposes of calculation of the charitable deduction. This low AGI would serve to limit the charitable contribution deduction for the year, but the taxpayer would then have to make a second computation to determine his or her ultimate tax liability for the year. In the second computation, the taxpayer could not use the $100 NOL because it was a tax attribute subject to reduction. Under the Tenth Circuit's analysis, the taxpayer would pay twice for the COD income exclusion: the charitable contribution deduction would be limited as if there were an NOL lowering his or her AGI, yet the final tax liability would be calculated without the benefit of the NOL attribute.

Other courts that have considered the time for attribute reduction under § 108(b)(4)(A), outside of the S corporation context, have uniformly held that attribute reduction is not made until after the tax liability for the year is computed. In *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam, adopting the opinion of the Tax Court*, 62 F.3d 136 (5th Cir. 1995), the Tax Court and the Fifth Circuit considered the application of the attribute reduction rules in the consolidated return setting, and held that tax attribute reduction under § 108(b)(4) does not occur "until the next taxable year." *CSI Hydrostatic Testers*, 103 T.C. at 414-415.[23]

Virtually all of the commentators who have considered the issue, including the highly regarded Collier on Bankruptcy Taxation, have concluded that the timing rule of § 108(b)(4) requires the reduction in attributes as of the beginning of the subsequent taxable year. MYRON M. SHEINFELD, FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.03[4][b][i], at 6-103 (Matthew Bender, 1999); Fred T. Witt, Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Task Force*, 46 TAX LAW. 209, 234 (1992); Lisa M. Hebenstreit, *Tying Together the Tax and Bankruptcy Codes*, 54 OHIO ST. L.J. 859, 889 n.21 (1993); and TAX MANAGEMENT PORTFOLIO 731: *S Corporation Operations*, § III.B.1.a at note 414.2 (1999).[24]

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[23] Similarly, in *Kahle v. Commissioner*, T.C.M. (RIA) 97,091, the Tax Court held that, under § 108(b)(4), the taxpayer estate "may use the tax attributes to determine its tax liability for the year of discharge, after which the tax attributes are reduced by the estate under section 108(b)(2). . . . "

[24] The sole authority cited by the *Gitlitz* court in support of its conclusion regarding the timing of attribute reduction is a treatise, C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF

E. The Position That COD Income Is "Tax Deferred" Income Rather Than "Tax-Exempt" Is Incorrect.

The Commissioner has strenuously argued that excluded COD income is not "tax-exempt," but "tax deferred." The Commissioner apparently reasons that if excluded COD income were considered "tax-exempt income," as described in § 1366(a)(1)(A), then it would have to be "taken into account" by shareholders and would result in basis adjustments. The Tax Court agreed with this argument in *Nelson*.

As to the significance of this argument to the ultimate issue, the Third Circuit stated succinctly in *Farley*:

> However, this disagreement between the Government and the Farleys as to the nature of discharge of indebtedness income has little relevance. . . .
>
> The statute is clear – all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to section 1366(a)(1)(A).

Farley, 202 F.3d at 210.

1. Excluded COD Income Is Not "Tax Deferred" Income.

Even if the classification of COD income as "tax deferred," as opposed to "tax-exempt," were considered

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BANKRUPTCY LAW AND PRACTICE, § 25:6, at 25-6 (3d ed. 1997). In a discussion of § 1398 (which coordinates the transfer of tax attributes between individual taxpayers in Chapter 11 and their bankruptcy estates), the treatise states, without analysis, that § 108(b)(4) provides "that tax attribute reduction must be made for the taxable year of the discharge."

significant, the application of the "tax deferred" characterization to excluded COD income does not withstand scrutiny.

First, and foremost, no statutory language supports this characterization. Neither the statute nor the regulations use the term "tax deferred."

Second, the Commissioner's contention that income excluded under § 108(a)(1)(B) is not "permanently exempt" because it is linked to attribute reduction ignores reality. Many taxpayers (1) have no tax attributes to reduce, (2) have COD income in excess of their tax attributes, or (3) have attributes to reduce, but the reduction never results in income recognition. *See Farley*, 202 F.3d at 210 (government concedes COD income is "sometimes" tax-exempt). In these instances, the § 108 exclusion will never result in any offsetting future increase in tax.

Although excluded COD income may be effectively "tax deferred" in some circumstances, i.e., dollar for dollar attribute reduction causes additional taxes to be paid in later years, this result does not mean that excluded COD income can always be considered "tax deferred." As the *Farley* court explained:

> Ultimately, the Government argues that since discharge of indebtedness income is sometimes deferred, it should always be considered tax deferred income. This argument suffers from one critical weakness – as the Government concedes, discharge of indebtedness income is sometimes tax exempt. If discharge of indebtedness income is sometimes tax-exempt income and sometimes tax deferred income, it is hard to see how the Government concludes, without more support for its position, that discharge of

> indebtedness income is simply tax-deferred income.

Farley, 202 F.3d at 210.

2. Excluded COD Income Is "Tax-Exempt" Income.

In an effort to avoid the inclusion of excluded COD income within the parenthetical of § 1366(a)(1)(A) as "tax-exempt income," the Commissioner has sought to differentiate income excluded under § 108 from income excluded under the other exclusions under Part III of Subtitle A of the Code. This is a difficult task because each of these provisions contains the same operative language: "gross income does not include. . . . " Moreover, the Commissioner's efforts in this regard are hampered by the fact that substantial prior usage of the term "exempt" in the Code and in Treasury Regulations belies the distinction that the Commissioner advances.

In the regulations governing the allocation and apportionment of deductions to income earned from domestic and foreign sources, Treasury has construed the phrase "exempt income" broadly to include all income which is "exempt, excluded or eliminated" for federal income tax purposes. Temp. Treas. Reg. § 1.861-8T(d)(2)(ii)(A). Treasury recognized that the ordinary, everyday meaning of the word "exempt" is "not subject to tax" and is synonymous with the term "excluded."

Section 139 uses the term "exemption" as a generic description of the exclusions in Part III (§§ 101-139). Section 139 is a cross-reference statute whose operative language provides that "for ***exemption*** of" certain items from income, a designated section of another Title should

be consulted.[25] Congress thus considered the statutes found in Part III to be, as a group, "exemptions" from tax, and, indeed, used the term "exemption" as a synonym for "exclusion."

In addition, the Consolidated Return Regulation governing parent basis in subsidiaries (which is similar to the rules for shareholder basis in S corporations) provides for a basis increase for tax-exempt income. Treas. Reg. § 1.1502-32(b)(2)(ii). The regulations treat substituted basis transactions (where recognition is deferred until a replacement asset is sold at a later date, e.g., §§ 118, 332, 351, and 1031) as not "tax-exempt." Treas. Reg. § 1.1502-32(b)(3)(ii)(A). However, the regulations explicitly characterize excluded COD income as a species of "tax-exempt income," which increases basis. Treas. Reg. § 1.1502-32(b)(3)(ii)(C)(1).[26]

Finally, in the case of partnerships, the passthrough entity on which S corporations were modeled, a partner's interest is increased by both the taxable income of the partnership and "income of the partnership exempt from tax under this title." § 705(a)(1).[27] Recently, the IRS issued

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[25] During 1991, the identical cross-reference statute was found at § 136.

[26] The regulation provides a special rule limiting the basis increase for excluded COD income, only allowing the increase to the extent of attribute reduction.

[27] When Congress adopted the partnership basis rules (upon which the Subchapter S rules are modeled), it described the rationale for adjusting a partner's interest for nontaxable income as follows:

> [A] partner's share of nontaxable income (such as exempt income or depletion allowances in excess of basis) is added to the basis of his interest in the

a Technical Advice Memorandum indicating that when a partnership receives COD income, a partner's pro rata share of that income increases that partner's basis, irrespective of whether that income is taxable or tax-exempt to the partner and irrespective of the fact that attributes may be reduced because of the COD income inclusion. Tech. Adv. Mem. 97-39-002 (September 26, 1997).[28] The TAM quoted extensively from the legislative history of § 108 and concluded that income excluded from tax under § 108(a) *does* increase basis under § 705 (the partnership analogue of § 1367), even though tax attributes may be reduced.

Given this prior substantial characterization of all excluded income, including COD income, as "tax-exempt," the Government's attempt to manufacture a metaphysical difference between "exclusion" and

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> partnership so that the benefit of such tax-exempt income will not be lost to the partner. Otherwise, a partner would eventually incur a capital gain with respect to such amounts. Similarly, the partner's share of nondeductible expenditures must be deducted from basis in order to prevent such amounts from eventually constituting capital loss to him.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 384 (1954), 1954 WL 6064 (Leg.Hist.) at *953, 1954 U.S.C.C.A.N. 4261.

[28] While this Technical Advice Memorandum is not official precedent under § 6110(k)(3), such rulings may be cited for the purpose of providing evidence of the Commissioner's interpretation (*Cantebury v. Commissioner*, 99 T.C. 223, 247 (1992) (*quoting Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962))), insight into the Commissioner's understanding of complex tax issues (*Capitol Fed. S & L Assoc. v. Commissioner*, 96 T.C. 204, 223 (1991)), or evidence of confusion in the Commissioner's interpretation or a change in position. (*Spencer v. Commissioner*, 43 F.3d 226, 234 (6th Cir. 1995)).

"exemption" linked to a potential reduction of attributes must be rejected.

F. Following The Statutory Scheme Merely Provides The Taxpayers With Benefits Afforded All Other Recipients Of Nontaxable Income – This Cannot Fairly Be Characterized As A Windfall.

Throughout the history of this litigation, the Commissioner has endeavored to advance a fundamental misconception: that permitting a shareholder stock basis increase for excluded COD income results in an unwarranted "windfall" to the shareholder. With that premise, despite having a position that ignores the language of the statutes and the regulations, the Commissioner convinced the Tax Court and the Tenth Circuit to construe the applicable statutes in such a manner so as to avoid the perceived windfall. The Tenth Circuit believed that permitting a taxpayer to exclude the income on one hand, and then to also obtain the benefit of a basis increase that permitted the use of additional losses, constituted "the equivalent of a double deduction." *Gitlitz*, 182 F.3d at 1147-1148.

However, there is *no* windfall if S corporation shareholders whose corporations realize excluded COD income only receive a benefit, which the statutes afford to all similarly situated taxpayers. Indeed, the Commissioner's position deprives some S corporation shareholders of benefits the Commissioner agrees are available to others. For example, the Commissioner does not dispute that when an S corporation realizes tax-free bond interest, the interest income passes through to the shareholders and increases their basis under §§ 1366 and 1367. The shareholder receives both an exemption from tax, as

well as an addition to basis that permits the use of suspended losses.[29] The "double benefit" abhorred by the Tenth Circuit is freely available to recipients of all items of nontaxable income.

Economically, the insolvent S corporation that receives the discharge of a liability is in exactly the same position as the insolvent S corporation that receives tax-exempt interest income. The first corporation's balance sheet is adjusted by the amount of the discharge (reduction in liabilities) just as surely as the balance sheet of the second corporation is adjusted by the tax-exempt interest (increase in assets). Unless a basis increase is made, the difference in net equity due to the discharge of debt could be subject to tax at the shareholder level by reason of a distribution of corporate assets to the shareholder, or upon the disposition of his or her stock in the corporation.

The Tenth Circuit reasoned that another tax policy reason for denying the Taxpayers a basis increase was the lack of any "economic outlay" associated with the receipt of COD income. *Gitlitz*, 182 F.3d at 1151. No valid rationale exists for denying the Taxpayers a basis increase on the grounds that excluded COD income was not obtained through an "economic outlay." *Farley*, 202 F.3d at 207 n.5; *Pugh*, 2000 WL 718215 at *6. Exempt COD income cannot be meaningfully differentiated from other forms of nontaxable income on the basis of economic outlay. Consider

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[29] If they had taken steps to protect their interests, the insolvent corporation's other creditors may have required that the corporation pledge the tax-exempt instrument, and required that proceeds from the corporation's investment be paid to them. Thus, distribution of tax-exempt income may not even be an option.

the corporation that collects on a $1 million life insurance policy on its officer, having paid $5,000 in premiums. The $995,000 in income is excludable under § 101, and increases shareholder basis. This situation is indistinguishable from the corporation that pays $5,000 in fees to obtain a $1 million loan that is later forgiven. While these two examples involve the same "economic outlay," the fact is that the shareholder basis increase for corporate income under §§ 1366(a)(1)(A) and 1367(a) is not conditioned upon any prior economic outlay.

The Commissioner's position in effect treats excluded COD income just as if it were fully taxable income and not subject to an exclusion under § 108. If the COD income had been taxable income, the Taxpayers would have increased their basis by the amount of the COD income. Suspended losses would then have been freed up, offsetting the taxable income and reducing the Taxpayers' basis under § 1367(a)(2)(B). The Taxpayers would have paid no tax, but would have had no suspended losses left at the end of the day. This is exactly the same position the Commissioner places the Taxpayers, although the Taxpayers are entitled to receive the benefit of an exclusion from tax. To avoid a perceived "windfall," the Tax Court and the Tenth Circuit unfairly denied any benefit flowing from the § 108(a) exclusion. Under the Commissioner's reasoning, the excluded COD income would be treated no differently than taxable COD income.

VII. CONCLUSION

The stock basis increases and loss deductions claimed by the Taxpayers are not only required by the language of the controlling statutes, but they are in accordance with

the purpose of the statutes as well. If a distinction is to be drawn between COD income and other forms of non-taxable income for purposes of determining shareholder basis, the distinction must be implemented through legislative action, not judicial amendment to carefully crafted rules.

Respectfully submitted this 29th day of June, 2000.

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26 C.F.R. § 1.1367-1

Sec. 1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

(a) In general – (1) Adjustments under section 1367. This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) Applicability of other Internal Revenue Code provisions. In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) Increase in basis of stock – (1) In general. Except as provided in Sec. 1.1367-2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) Amount of increase in basis of individual shares. The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of

the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) Decrease in basis of stock – (1) In general. The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) Noncapital, nondeductible expenses. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162.

(3) Amount of decrease in basis of individual shares. The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance

with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) Time at which adjustments to basis of stock are effective – (1) In general. The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) Adjustment for nontaxable item. An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2). If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under Sec. 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest

is terminated or a qualifying disposition occurs, whichever the case may be.

* * *

FOR ARGUMENT

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v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation. During 1991, that corporation obtained a discharge of certain indebtedness. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(B). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioners as the shareholders of the Subchapter S corporation, thereby increasing their basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing them to deduct losses they were previously unable to deduct because they had exhausted their basis by prior deductions.

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In the Supreme Court of the United States

No. 99-1295

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 182 F.3d 1143. The initial opinion of the Tax Court (Pet. App. 25-31) is unofficially reported at 73 T.C.M. (CCH) 3167. The opinion of the Tax Court on reconsideration, which withdrew and replaced the initial opinion (Pet. App. 21-24), is unofficially reported at 75 T.C.M. (CCH) 1840.

JURISDICTION

The judgment of the court of appeals was entered on July 6, 1999. A petition for rehearing was denied on November 3, 1999 (Pet. App. 32-33). The petition for a writ of certiorari was filed on February 1, 2000, and was

granted on May 1, 2000. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 108, 1366 and 1367 of the Internal Revenue Code, 26 U.S.C. 108, 1366, 1367, are set forth at Pet. App. 34-58.

STATEMENT

1. a. During the 1991 taxable year, petitioners David A. Gitlitz and Philip D. Winn each owned a 50% interest in P.D.W. & A., Inc., a Colorado corporation that elected to be taxed for that year under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 2-3. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

The Subchapter S corporation was a partner in a partnership that was discharged from $4,154,891 in debt during 1991. Pet. App. 3. The corporation's share of the discharged debt was $2,021,296. This amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) except that, at the time of the discharge, the corporation was insolvent.[1] Because the corporation was insolvent, this amount was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which

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[1] Prior to the discharge of indebtedness, the liabilities of the Subchapter S corporation exceeded the fair market value of its assets by $2,181,748. Pet. App. 3.

* * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).[2]

b. Although Section 108 of the Code thus specifies that discharge of indebtedness is *not* an item of income for an insolvent corporation, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at

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[2] For partnerships, the Section 108 exclusion applies "at the partner level" (26 U.S.C. 108(d)(6)) rather than at the partnership level. For Subchapter S corporations, however, the Section 108 exclusion applies "at the corporate level" (26 U.S.C. 108(d)(7)(A)) rather than at the shareholder level. When, as in this case, an insolvent S corporation is a partner in a partnership that has been discharged from debt, these provisions make the insolvency of the corporation (rather than of the partnership or of the shareholders of the Subchapter S corporation) controlling in determining whether the exclusion from income is available under Section 108.

the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioners had previously deducted losses representing their entire basis in their stock. Pet. App. 3-4. At the time the indebtedness of the Subchapter S corporation was discharged in 1991, petitioners would thus be allowed further deductions from the corporate losses only if their basis in the corporate stock were somehow increased.[3]

Petitioners assert that the additional basis that they need in order to take further deductions from the losses of the Subchapter S corporation can be found in the discharge of indebtedness "income" of the corporation in 1991. They assert that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) that increases their basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. On that theory, petitioners claimed additional deductions in amounts equaling their allocable shares of the discharged debt of $2,021,296. Pet. App. 3.[4]

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[3] The losses of the corporation incurred prior to 1991, which petitioners had been unable to deduct because they had exhausted their basis, are described as "suspended" losses and are carried into future years. They may be deducted in future years only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

[4] Petitioner Gitlitz claimed the deduction on his 1991 tax return, while petitioner Winn claimed the deduction on his 1992 return. Pet. App. 4 n.3.

Upon audit, the Commissioner determined that petitioners were not entitled to increase their stock basis by their reported *pro rata* shares of the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the deductions claimed by petitioners and asserted a deficiency of $251,192 against petitioner Gitlitz and of $242,555 against petitioner Winn. Pet. App. 64-66, 81-83.

2. Petitioners filed separate petitions in the Tax Court that were consolidated for disposition. On cross-motions for summary judgment, the Tax Court initially ruled in favor of petitioners. Pet. App. 25-31. The court stated (*id.* at 29-30) that, because income from the discharge of indebtedness is an item of income in the general definition of gross income (26 U.S.C. 61(a)(12)), it qualifies as an "item[] of income" for which an upward basis adjustment is appropriate under 26 U.S.C. 1366(a)(1)(A) even though, due to the insolvency of the debtor, it is excluded from income under Section 108(a)(1)(B).

The Commissioner moved for reconsideration. While that motion was pending, the entire Tax Court held in a reviewed decision that a discharged debt that is excluded from a Subchapter S corporation's gross income because of its insolvency does *not* constitute an item of "income" that would increase the shareholder's basis in the corporate stock (and thereby allow deductions of losses after that basis has been exhausted by prior deductions). *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999). Relying on its decision in *Nelson*, the Tax Court then granted the motion for reconsideration in this case and entered decisions in favor of the Commissioner. Pet. App. 21-24.

3. The Tenth Circuit affirmed. Pet. App. 1-20.[5] The court of appeals emphasized that petitioners' proposed interpretation of the Code would accomplish an inappropriate double tax benefit for taxpayers: it would permit the insolvent Subchapter S corporation to avoid tax on the discharged debt (an item that is "not" treated as an item of income for insolvent corporations under Section 108(a)) but, at the same time, allow the shareholders of the corporation to reduce their gross income from *other* sources by treating the discharged debt as if it *were* an item of "income," thereby increasing their basis in the corporate stock and permitting deductions otherwise barred by the prior exhaustion of that basis. Pet. App. 10. The court noted that this Court has emphasized that the Internal Revenue Code "should not be interpreted to allow taxpayers the practical equivalent of a double deduction absent a clear declaration of intent by Congress." *Ibid.* (quoting *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969)). The court concluded that "only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here" (Pet. App. 10) and held that petitioners did not meet that burden in this case.

The court noted that a discharge of indebtedness does not constitute an item of income under Section 108(a) if "the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent" (Pet. App. 9) and that this characterization of the item

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[5] The taxpayer in *Nelson* v. *Commissioner* also appealed the Tax Court's decision in that case to the Tenth Circuit. The court of appeals affirmed the Tax Court's decision on the authority of its opinion in this case. *Nelson* v. *Commissioner*, 182 F.3d 1152 (10th Cir. 1999). The taxpayer in *Nelson* did not file a petition for a writ of certiorari.

is necessarily made and "applied at the *corporate* level" (*id.* at 11 (citing 26 U.S.C. 108(d)(7)(A)). See note 2, *supra*. The court explained that petitioners' effort nonetheless to treat it as an "item[] of income" under Section 1366 ignores and "effectively eliminate[s] the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108." Pet. App. 13. That "price" is set forth in Section 108(b), which requires the insolvent corporation to reduce various "tax attributes" (such as carried over credits or losses) "that could otherwise yield future tax benefits." *Id.* at 9. In deciding in Section 108 to "not" treat a discharge of debts owed by an insolvent as "income," Congress did not mean to provide additional tax benefits to the corporate shareholders in the manner proposed by petitioners; instead, Congress determined in Section 108(b) to reduce the preexisting tax carryforwards available to the corporation that might yield "future tax benefits." Pet. App. 9. The court concluded that petitioners' interpretation of these statutes "would negate the effect of the tax attribution scheme and would give [petitioners] an unwarranted windfall." *Id.* at 16.[6]

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[6] The court of appeals provided several examples that illustrate the interplay among Sections 108, 1366 and 1367. Pet. App. 16-18 n.6. The court noted that the amount excluded from an insolvent S corporation's gross income under Section 108 can not pass through to its shareholders to increase their basis under Sections 1366 and 1367 because: (i) the debt discharge amount is first applied to reduce the corporation's favorable tax attributes (including any suspended shareholder losses which, under Section 108(d)(7)(B), are treated for this purpose as net operating losses of the Subchapter S corporation); and (ii) "[a]ny further remaining debt discharge amount is [to be] disregarded, i.e., does not result in income or have other tax consequences." Pet. App. 9 (quoting S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980)).

SUMMARY OF ARGUMENT

Long prior to the enactment of the provisions of the Internal Revenue Code involved in this case, judicial decisions and Treasury rulings had both made clear that a discharge of indebtedness does *not* constitute an item of "income" for an insolvent corporation. In enacting Section 108 of the Code in 1980, Congress embraced and codified that established rule by expressly providing that the discharge of a debt does "not" constitute income to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(B). Congress nonetheless determined, however, that it was appropriate to impose a price for this economic benefit for insolvent taxpayers by requiring them to use the amount of such discharged debt to reduce or eliminate certain favorable "tax attributes" that they otherwise could employ to reduce their taxable income in future years. 26 U.S.C. 108(b)(1)-(2). For insolvent Subchapter S corporations, those tax attributes include the "suspended" corporate losses that the shareholders were unable to deduct because they lacked sufficient basis in the stock of the corporation. Under Section 108(d)(7)(B) of the Code, such losses are treated as "net operating losses" of the corporation and any amount of discharged debt of insolvent Subchapter S corporations is to be set off against those losses to reduce or eliminate them. As the legislative history of Section 108 clearly states, "[a]ny further remaining debt discharge amount is [then to be] disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. 2, 13 (1980).

In this case, petitioners' insolvent S corporation was discharged from a debt in 1991. Petitioners contend that the debt discharge to that insolvent corporation—an item that has never been regarded as an item of

"income" in the lengthy history of the federal income tax and that Congress expressly specified is "not" income to the corporation in enacting Section 108(a)(1)(B)—is nonetheless an "item[] of income" of the corporation within the meaning of Section 1366(a)(1)(A) that increases shareholder stock basis under Section 1367(a)(1)(A) and thereby allows petitioners to take deductions for losses "suspended" under Section 1366(d)(1) for lack of basis. The courts that have considered petitioners' contention have recognized that petitioners are seeking to obtain the "windfall" of a double tax benefit from the debt discharge: they would avoid payment of tax on the amount that is "not" treated as an item of income under Section 108 and would also obtain an upward basis adjustment for their corporate stock under Section 1367 that would enable them to deduct otherwise nondeductible losses.

Petitioners' argument conflicts with the plain language of the provisions of Sections 1366 and 1367 that limit basis adjustments to "items of income" received by the corporation. Their contention would also nullify the statutory mandate (in Sections 108(b)(2)(A) and 108(d)(7)(B)) that the amount of discharged debt that is "not" an item of income for the insolvent corporation is to be applied to reduce (or eliminate) the very suspended corporate losses (and other favorable tax attributes of the corporation) that petitioners seek instead to deduct. Petitioners thus seek to obtain a double tax benefit in a context where Congress plainly sought to reduce the benefit, not double it. The erroneous interpretation of these provisions for which petitioners contend would improperly transmute a statute that was designed as a method of deferring the tax on debt forgiveness into a mechanism for avoiding tax on the

unrelated income of shareholders of insolvent S corporations.

ARGUMENT

THE AMOUNT OF DEBT DISCHARGED FOR AN INSOLVENT SUBCHAPTER S CORPORATION IS NOT AN ITEM OF "INCOME" THAT FLOWS THROUGH TO THE SHAREHOLDERS OF THE CORPORATION UNDER SECTION 1366(a) OR INCREASES THEIR BASIS IN THE STOCK OF THE CORPORATION UNDER SECTION 1367(a)

A. The Discharge Of A Debt Is Not An Item Of "Income" To An Insolvent Corporation

The intricate and interrelated tax statutes involved in this case are best understood in the context of the unique history in which they were developed and enacted. Long prior to the enactment of the provisions of the Internal Revenue Code involved in this case, judicial decisions and Treasury rulings had uniformly concluded that a discharge of indebtedness does *not* constitute an item of "income" for an insolvent corporation. In enacting Section 108 of the Code in 1980, Congress embraced and codified that established rule by specifying that the discharge of a debt does "not" constitute income to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(B). Since the debt discharge of an insolvent corporation does not give rise to "income," there is no "item of income" that passes through to the shareholders to increase their basis under Sections 1366 and 1367.

1. The concept of "income" has a "sweeping scope" and is broad enough to include all "accessions to wealth." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429, 431 (1955). In 1931, this Court held in

United States v. *Kirby Lumber Co.*, 284 U.S. 1, that a *solvent* taxpayer realizes "income" from the discharge of indebtedness. The Court reasoned that the taxpayer made a "clear gain" when it repurchased for a lesser amount bonds that it had issued at par, for it thereby "made available * * * assets previously offset by the obligation of bonds now extinct." *Id.* at 3. As the Court has further explained, a solvent taxpayer realizes "income" when he is "released from his obligation to repay" a debt, for he "enjoys a net increase in assets equal to the forgiven portion of the debt * * * ." *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573, 582 (1991). In adding Section 61(a)(12) to the Code in 1954, Congress codified the result of these decisions by specifying that gross income includes "[i]ncome from discharge of indebtedness." 26 U.S.C. 61(a)(12).

Notwithstanding the facial breadth of this statute, the Treasury Department and the courts have uniformly concluded that a discharge of indebtedness does *not* constitute "income" for an *insolvent* corporation. In adopting what became known as the judicial "insolvency exception" to the tax rules governing the treatment of the discharge of indebtedness, the courts explained that the rationale of *Kirby Lumber* does not apply to a taxpayer who is insolvent at the time the debt is discharged and remains so afterward.[7] See, *e.g.*, *Dallas Transfer & Terminal Warehouse Co.* v.

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[7] Although the conclusion that an insolvent taxpayer realizes no income from the discharge of indebtedness has been referred to as the "judicial insolvency exception," the exception originated in a 1923 Treasury ruling (I.T. 1564, II-1 C.B. 59 (1923)) that was confirmed by Treasury regulations adopted as recently as 1957. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.1, at 7-56 n.1 (3d ed. 1999).

Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. 798, 801 (1949) (collecting cases). These courts held that the forgiveness of a debt does not represent "income" for an insolvent taxpayer because, unlike the solvent taxpayer in *Kirby Lumber*, an insolvent taxpayer does not experience an increase or "freeing up" of any assets by reason of the discharge. *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96; see 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 6.4.6, at 6-58 n.97 (2d ed. 1989). The court explained in *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96, that, when an insolvent is discharged from debt, no "income" is realized because the insolvent does not "acquir[e] something of exchangeable value in addition to what [it] had before. * * * There is an absence of such a gain or profit as is required to come within the accepted definition of income." As the Tax Court stated in *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. at 801, when the "remaining obligations" of the insolvent taxpayer continue to exceed its remaining assets, no "income" is realized from the discharge of a debt because "no assets were freed from the claims of creditors by [the] discharge."

Even after Congress added Section 61(a)(12) to the Code in 1954 specifically to enumerate "[i]ncome from discharge of indebtedness" as an item of "income" (26 U.S.C. 61(a)(12)), the Treasury confirmed in implementing regulations that the longstanding judicial "insolvency exception" remained in force. 26 C.F.R. 1.61-12(b)(1). Since 1957, this regulation has specified that "[i]ncome is not realized by a taxpayer" by the discharge of his indebtedness "if immediately thereafter

the taxpayer's liabilities exceed the value of his assets." *Ibid.* See T.D. 6272, 1957-2 C.B. 18, 31.[8]

2. In 1980, Congress embraced and codified this well-established "insolvency exception" by specifying in Section 108(a) of the Code that the discharge of a debt does "not" constitute an item of "income" to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(A). This provision was enacted as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389. In enacting that legislation, Congress noted that, while "[u]nder present law, income is realized when indebtedness is forgiven, * * * [t]here are several exceptions to the general rule." S. Rep. No. 1035, *supra*, at 8. In particular, "[u]nder a judicially developed 'insolvency exception,' *no income arises from discharge of indebtedness if the debtor is insolvent* both before and after the transaction." *Ibid.* (emphasis added).

In codifying this longstanding "insolvency exception," Section 108(a) of the Code specifies that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).[9] At the

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[8] This regulation confirmed the ruling issued in 1923, in which the Treasury Department first expressed the conclusion that the discharge of indebtedness does *not* constitute an item of "income" to an insolvent entity. See note 7, *supra*.

[9] The amount of discharged debt that does not represent "income" under Section 108(a)(1)(B) may not exceed the amount by which the taxpayer is insolvent. 26 U.S.C. 108(a)(3). Section 108(d)(3) defines the term "insolvent" as "the excess of liabilities over the fair market value of assets," and provides that insolvency is to "be determined on the basis of the taxpayer's assets and

same time, however, Congress determined that it was appropriate to impose a price for this preferential treatment of insolvent taxpayers—a price that had *not* been imposed under the judicial "insolvency exception." See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed. 1999), The price that Congress imposed is the requirement added by Section 108(b) that the taxpayer must use the amount of the discharged debt to reduce or eliminate certain favorable "tax attributes" that the taxpayer could otherwise employ to reduce its taxable income in future years. 26 U.S.C. 108(b)(1), (2).[10] The favorable

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liabilities immediately before the discharge." 26 U.S.C. 108(d)(3). Section 108 provides the same treatment for the discharge of a debt in a bankruptcy case and for the discharge of "qualified farm indebtedness." 26 U.S.C. 108(a)(1)(A), (C).

[10] Under Section 108(b)(1), the amount excluded from gross income under Section 108(a)(1) "shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." 26 U.S.C. 108(b)(1). Section 108(d)(7)(A) prescribes that, in the case of discharge of indebtedness by a Subchapter S corporation, Sections 108(a) and 108(b) "shall be applied at the corporate level." 26 U.S.C. 108(d)(7)(A).

Under Section 108(b)(2), the amount excluded under Section 108(a)(1) is generally applied to reduce the following tax attributes in the following order: (i) any net operating loss for the taxable year of the discharge and any net operating loss carryover to the taxable year of the discharge, (ii) a general business credit, (iii) capital loss carryovers, (iv) the basis of property of the taxpayer, and (v) foreign credit tax carryovers. 26 U.S.C. 108(b)(2)(A)-(G). The reductions are dollar for dollar for net operating losses, capital loss carryovers and basis reduction, and 33.33 cents for each dollar excluded under Section 108(a) for the general business credit and foreign tax credit carryovers. 26 U.S.C. 108(b)(3)(A) & (B). Section 108(d)(7)(B) defines the "net operating loss" of a Subchapter S corporation, for the purposes of Section 108(b)(2)(A), to include "any loss or deduction which is disallowed for the taxable year of

"tax attributes" that Congress specified are to be reduced by the amount of the discharged debt include the insolvent's net operating losses, its basis in property, its capital loss carryovers, and other specific items set forth in the detailed provisions of Section 108(b). See note 10, *supra*. In enacting this provision in 1980, Congress clearly stated its understanding and intent that any portion of the debt discharge amount remaining *after* application against these specified tax attributes was then to be "disregarded, i.e., *does not result in income or have other tax consequences.*" S. Rep. No. 1035, *supra*, at 2, 13 (emphasis added).[11] As Professors Bittker and Lokken have explained, when the favorable tax attributes of the insolvent corporation are insufficient to absorb all of the debt discharge amount, "the unabsorbed amount is not gross income" and is therefore to be "ignored." 1 B. Bittker & L. Lokken, *supra*, at 7-58.[12]

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the discharge under section 1366(d)(1)." 26 U.S.C. 108(d)(7)(B). The "suspended" losses of the shareholders, which can not be deducted due the exhaustion of their basis in the corporate stock, are thereby defined as a "net operating loss" of the corporation for tax attribution reduction under Section 108(b).

Under Section 108(b)(5), the taxpayer may elect to apply any portion of the reduction referred to in Section 108(b)(1) to reduce "the basis of the depreciable property of the taxpayer." 26 U.S.C. 108(b)(5). Section 1017(a)(2) provides that "such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." 26 U.S.C. 1017(a)(2).

[11] Congress provided in Section 108(e)(1) that "[e]xcept as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness." 26 U.S.C. 108(e)(1).

[12] "In this situation, §§ 108(a) and 108(b) preserve an anomaly from the law predating their enactment in 1980, when a bankrupt

By thus using the amount of the discharge of indebtedness that does *not* represent an item of "income" for an insolvent taxpayer to reduce certain prospectively favorable tax attributes of the taxpayer, Congress sought to employ Section 108 as a tax-deferral, rather than a tax-forgiveness, mechanism: the taxpayer avoids immediate payment of tax from the debt discharge but pays potentially greater taxes in future years as a result of the discharge. "[T]he rules of the [statute] are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." S. Rep. No. 1035, *supra*, at 10. As this Court stated in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991), "the effect of § 108 is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's" ability prospectively to employ any favorable tax attributes existing at the time the discharge occurred. *Id.* at 580.[13]

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or insolvent taxpayer was excused from recognizing debt discharge income and suffered no collateral consequence." 1 B. Bittker & L. Lokken, *supra*, at 7-58.

[13] The 1980 amendments to Section 108 had no specific provisions for Subchapter S corporations. The statute, however, provided special rules for applying the provisions of Section 108(a) and (b) to partnerships. Section 108(d)(6) provided (and continues to provide) that the exclusion from gross income (in Section 108(a)) and the reduction in tax attributes (in Section 108(b)) occur "at the partner level." 26 U.S.C. 108(d)(6). See note 2, *supra*.

In the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 3(e), 96 Stat. 1689, Congress amended Section 108(d)(6) to provide that, in the case of S corporations, the exclusion from gross income and the reduction in tax attributes were to occur at the shareholder level, thereby treating S corporations and partnerships similarly. In 1984, however, Congress altered that result by

B. The Discharge Of A Debt Of An Insolvent Subchapter S Corporation Is Not An Item Of "Income" Or "Tax Exempt Income" That Flows Through To Shareholders And Increases Their Basis In The Corporate Stock Under Sections 1366 And 1367 Of The Code

Although Section 108 of the Code thus adopts the longstanding rule that a discharge of indebtedness is *not* an item of income for an insolvent corporation, petitioners claim that such a discharge should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of Subchapter S corporations. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or

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enacting Section 108(d)(7), which provides that, for Subchapter S corporations, (i) the exclusion and the attribute reduction are to take place at the corporate level and (ii) that any shareholder loss disallowed for the year of the discharge under Section 1366(d)(1) is, for purposes of tax attribute reduction under Section 108(b), to be treated as a net operating loss of the corporation for that year. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(b), 98 Stat. 966. The purpose of the 1984 amendment is "to treat all shareholders in the same manner" (H.R. Rep. No. 432, 98th Cong., 1st Sess. 334 (1983)) by making "the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses which are not allowed by reason of any shareholder's basis limitation) [operate] at the corporate level." *Ibid.* The 1984 amendment "t[ook] effect as if included in the Subchapter S Revision Act of 1982" (Pub. L. No. 98-369, § 721(y)(1), 98 Stat. 972), and the 1982 provisions that would have made the exclusion and attribute reduction operative at the shareholder level were thus never effective. Petitioners' citation (Pet. Br. 27) of the provisions of the former Section 108(d)(6)—provisions that Congress rejected and that were never applicable for Subchapter S corporations—is thus plainly incorrect.

credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)).

At the time the indebtedness of the Subchapter S corporation involved in this case was discharged in 1991, petitioners had previously deducted losses representing their entire basis in the stock. Pet. App. 3-4. They would thus be allowed further deductions from the corporate losses only if their basis in the corporate stock were somehow increased. 26 U.S.C. 1366(d)(2). Petitioners contend that the debt discharge of their insolvent Subchapter S corporation—a discharge that is "not" an item of income under Section 108—is nonetheless to be treated as if it were an "item of income" of the corporation within the meaning of Section 1366(a)(1)(A), which would increase their basis in the corporate stock under Section 1367(a) and allow them to take deductions for losses "suspended" when they had previously exhausted their basis by taking other loss deductions. The court of appeals correctly rejected that claim.

1. Petitioners improperly seek to characterize an item as "income" when Congress has instead specified that it is "not" income. 26 U.S.C. 108(a). As all of the courts that have considered this issue have observed, petitioners' application of this statutory text would accomplish a double tax benefit from the discharged debt of the Subchapter S corporation: their inter-

pretation would not only avoid payment of any tax on the discharged debt but it would also yield an upward basis adjustment for the corporate stock equal to that amount, which would enable petitioners to deduct "suspended" corporate losses against any unrelated income received by petitioners from other sources.[14] Petitioners thus seek to *obtain* a tax benefit from a statute that was enacted by Congress to *reduce or eliminate* tax benefits. In short, petitioners would transmute a statute that was designed as a method of *deferring* the tax on debt forgiveness into a mechanism for *avoiding* tax on unrelated income of shareholders of insolvent Subchapter S corporations. In addressing the defects in petitioners' erroneous parsing of these statutory provisions, it is therefore appropriate to note the wisdom of the advice of eminent tax counselors that "the lawyer's passion for technical analysis of the statutory language should always be diluted by distrust of a result that is too good to be true." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.51, at 14-170 (5th ed. 1987).

a. To begin with, it is incorrect to characterize the discharge of a debt as giving rise to "income" for an insolvent taxpayer. Neither the statute nor the applicable court decisions or administrative rulings characterize the discharge of debt for an insolvent corporation as an item of "income." For decades prior to the enactment of the Bankruptcy Tax Act of 1980, including many years after Section 61(a)(12) of the Code was enacted generally to include "[i]ncome from dis-

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[14] As the court stated in *Pugh* v. *Commissioner*, 213 F.3d 1324, 1330 (11th Cir. 2000), petitioners' reasoning "can lead to the result that shareholders actually benefit from their S corporation's insolvency."

charge of indebtedness" in gross income, the Treasury and the courts had consistently ruled that a discharge of indebtedness for an insolvent taxpayer does not "come within the accepted definition of income." *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96. See pages 10-13 & note 7, *supra*. In enacting Section 108, Congress endorsed and codified this preexisting, established rule that "*no income arises* from discharge of indebtedness if the debtor is insolvent." S. Rep. No. 1035, *supra*, at 8 (emphasis added). Moreover, in providing in Section 108 that an insolvent taxpayer's debt discharge is "not" income (26 U.S.C. 108(a)(1)(B)), Congress emphasized that any debt discharge amount remaining after application against the tax attributes set forth in the statute is to be "disregarded" because it "*does not result in income or have other tax consequences.*" S. Rep. No. 1035, *supra*, at 2 (emphasis added). See also *id.* at 13 (same).

In requiring in Section 108(b) that the insolvent corporation apply the amount of such forgiven indebtedness to *reduce* its favorable tax attributes (see note 10, *supra*), Congress plainly did not intend to transform the discharge amount into an "item of income" that would flow through to the taxpayer and *enhance* its favorable tax attributes under Section 1366(a)(1)(A). Instead, any discharge amount remaining after application against favorable tax attributes is to be "disregarded" because "the unabsorbed amount is not gross income" and is therefore to be "ignored." 1 B. Bittker & L. Lokken, *supra*, at 7-58. See note 12, *supra*.

In view of this clear legislative history, petitioners' disregard of the plain, limiting text of this statute is fatal to their claim. It is an established "rule that tax-exemption and -deferral provisions are to be construed

narrowly" (*United States* v. *Centennial Savings Bank FSB*, 499 U.S. at 583) and that "the Code should not be interpreted to allow [taxpayers] 'the practical equivalent of double deduction * * * .'" *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (quoting *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934)).

b. Petitioners also err in contending (Pet. Br. 47-48), in the alternative, that the discharge of the debt of an insolvent taxpayer constitutes an item of "tax exempt income" that would flow through to the shareholders under Section 1366(a) and increase their basis under Section 1367(a). The most fundamental reason why the amount of a discharged debt of an insolvent is not "tax exempt income" is that this amount does not represent "income" of any type.[15] Unlike "tax exempt income" (such as state and local bond interest) which represents an "undeniable accession[] to wealth" (*Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. at 431) and thus plainly

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[15] The decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198, 209 (2000), petition for cert. pending, No. 99-1675, and of the Eleventh Circuit in *Pugh* v. *Commissioner*, 213 F.3d at 1331, erred in this regard by equating the discharged debt of an insolvent under Section 108 with the category of "tax-exempt income" that passes through to shareholders to increase their stock basis under Sections 1366 and 1367. The court in *Pugh* did so reluctantly, for it "acknowledge[d] the justice of the Commissioner's position, for unlike other sources of tax-exempt income, [debt discharge] income becomes tax-exempt merely from the infelicitous combination of corporate insolvency and a lack of tax attributes to offset the [debt discharge] income [under Section 108(b)]." 213 F.3d at 1331. What these courts failed to recognize, however, is that the debt discharge of an insolvent is not only not "tax-exempt income," it is not an item of "income" at all. See S. Rep. No. 1035, *supra*, at 8 ("no income arises from a discharge of indebtedness if the debtor is insolvent"); 1 B. Bittker & L. Lokken, *supra*, at 7-58; pages 10-13 & note 7, *supra*.

constitutes "income," the amount of a discharged debt of an insolvent has not been regarded as yielding an accession to wealth and has instead consistently been held by the courts and the Treasury *not* to come within the definition of "income" at all. See pages 10-13 & note 7, *supra*. In enacting Section 108, Congress adopted—it did not alter or discard—the established rule that the discharged debt of an insolvent is simply "not" an item of "income" of any type. 26 U.S.C. 108(a). See S. Rep. No. 1035, *supra*, at 2, 8.

Moreover, although "[t]here is no definition of 'tax-exempt' for purposes of section[ ] 1366," the term inherently signifies an item that is "exempt on a permanent basis." *Nelson* v. *Commissioner*, 110 T.C. at 125. The statutory provisions that concern "tax-exempt income" address items such as life insurance proceeds and state and local bond interest, which not only are excluded from income in the year received (26 U.S.C. 101, 103) but also are *not* accompanied with the offsetting reductions in tax attributes that make debt discharge income "subject to taxation in the future." 110 T.C. at 125. As this Court explained in *Centennial Savings Bank*, due to the offsetting adjustments of tax attributes required for debt discharge items under Section 108, the result of the statute "is not genuinely to exempt such income from taxation * * *." 499 U.S. at 580.[16]

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[16] In 1999, the Treasury Department promulgated Treas. Reg. 1.1366-1(a)(2)(viii). That regulation formally specifies that the amount of any discharge of indebtedness of an insolvent Subchapter S corporation is *not* "tax-exempt income" within the meaning of the basis adjustment rules of Sections 1366 and 1367. 64 Fed. Reg. 71,641 (Dec. 22, 1999). The regulation is effective only for taxable years beginning on or after August 18, 1998, and thus does not, by its terms, apply to this case. 26 C.F.R. 1.1366-5.

When tax exempt items—such as life insurance proceeds and state or local bond interest—are received by a Subchapter S corporation and passed through to its shareholders under Section 1366(a)(1)(A) as "items of income (including tax-exempt income)," the shareholders receive an *upward* basis adjustment (under Section 1367(a)(1)(A)) that is offset by a corresponding *downward* basis adjustment (under Section 1367(a)(2)(A)) when that income is distributed to the shareholder. 26 U.S.C. 1367(a)(2)(A). See pages 3-4, *supra*. As the Tenth Circuit explained in this case (Pet. App. 8-9), the temporary basis increase under Section 1367 for these items of "tax-exempt income" is logically required to preserve the tax-exempt character of the income at the shareholder level. In the absence of that basis increase, the shareholder would be subject to tax upon the distribution of the income under Section 1368(b)(2) of the Code, for any distribution of cash or property that exceeds a shareholder's adjusted basis in stock is treated as gain from the sale or exchange of property. 26 U.S.C. 1368(b)(2).

By contrast, as the Treasury Department and the courts have long recognized, when an insolvent is discharged from debt, the corporation acquires no asset for distribution in cash or in kind to its shareholder. Because the corporation is insolvent, "there is a reduction or extinguishment of liabilities without any increase of assets." *Dallas Transfer & Terminal Warehouse* Co. v. *Commissioner*, 70 F.2d at 96. If (as petitioners contend) an upward basis adjustment occurred under Section 1367 in this context, it would thus *not* be followed by a corresponding downward basis adjustment, for there is no "distribution" associated with the

discharge of an insolvent corporation's indebtedness.[17] An upward basis adjustment in this context would serve no purpose other than to defeat the plain mandate of Congress that the discharge of indebtedness is "not" to be treated as "income" to an insolvent corporation (26 U.S.C. 108(a)(1)(B)) and that any amount of the discharged debt remaining after application against the taxpayer's favorable tax attributes under Section 108(b) has no "tax consequences" and is simply to be "disregarded" (S. Rep. No. 1035, *supra*, at 2, 13).

c. Petitioners incorrectly assert (Pet. Br. 18-21, 46) that Treasury regulations have characterized the debt discharge of an insolvent Subchapter S corporation as giving rise to "tax-exempt income." The brief portion of the regulations cited by petitioners simply paraphrases the statutory basis adjustment for "tax-exempt income" (26 U.S.C. 1366(a)(1)(A)) as an adjustment that applies to "nontaxable item[s]" of income (26 C.F.R. 1.1367-1(d)(2)). Nothing in that abbreviated regulatory language purports to alter or enlarge the statutory text. The regulation merely employs a phrase that is similar, but not identical, to the statutory language in describing its effect.

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[17] Petitioners thus plainly err in arguing (Pet. Br. 47-49) that the treatment they seek for debt discharge of an insolvent taxpayer has no different consequence than the treatment of "tax exempt income" such as state and local bonds. The treatment of "tax exempt income" such as state and local bonds simply preserves the statutory exemption for those items of "income"; the treatment sought by petitioners for debt discharge of an insolvent taxpayer would create an addition to basis (and thereby permit additional deductions) for which no offsetting item of "income" exists. Indeed, it is through this very mechanism that petitioners seek to obtain a double tax benefit from the operation of these provisions. See, *e.g.*, Pet. App. 10; note 14, *supra*.

In particular, nothing in that regulation purports to conclude that the discharge of indebtedness of an insolvent Subchapter S corporation provides a basis adjustment for the shareholders of the corporation under Sections 1366 and 1367. That issue is not even remotely addressed in that regulation. There is, however, a different regulation—a regulation that petitioners have failed to cite—that actually *is* relevant to that issue. Since 1957, the Treasury has specified in its regulations that "[i]ncome is not realized" from the discharge of the debt of an insolvent. 26 C.F.R. 1.61-12(b)(1). This regulation conforms to the longstanding principle that the discharge of a debt of an insolvent does not represent an item of "income" of any type. See pages 10-13 & note 7, *supra*. By contrast, "tax-exempt income" is an item of actual "income" that a taxpayer has actually "realized," but that Congress has chosen, by statute, to exempt from tax. Section 108 does not make the discharge of indebtedness of an insolvent "exempt" from tax, for that item was never "income" subject to tax in the first place. See S. Rep. No. 1035, *supra*, at 8 ("no income arises from discharge of indebtedness if the debtor is insolvent").

Petitioners' reliance (Pet. Br. 21-22) on a similar abbreviated paraphrasing of the scope of the basis adjustment for "tax-exempt income" in the legislative history of the Subchapter S Revision Act of 1982 provision is inapposite for precisely these same reasons. Moreover, in describing these same statutory provisions in 1993, Congress stated its clear understanding that "[t]he shareholders' basis in their stock is *not* adjusted" by the amount of a discharged debt of an insolvent Subchapter S corporation. H.R. Rep. No. 111, 103d Cong., 1st Sess. 624-625 (1993) (emphasis added). That legislative state-

ment is, of course, precisely at odds with the interpretation of these provisions advocated by petitioners.[18]

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[18] Petitioners further err in claiming (Pet. Br. 46) that a Technical Advice Memorandum (T.A.M. 97-39-002) issued by the Internal Revenue Service in 1997 supports their position. This Technical Advice Memorandum serves as internal advice within the agency, and Congress has specified that such documents "may not be used or cited as precedent." 26 U.S.C. 6110(k)(3). In any event, the ruling contained in this Memorandum concerns partnership provisions that have no relevance to this case. The ruling addresses the fact that the insolvency rules for the discharged debt of a partnership are applied at the individual partner level (26 U.S.C. 108(d)(6)), whereas the insolvency rules for the discharged debt of a Subchapter S corporation are instead applied at the corporate level (26 U.S.C. 108(d)(7)). Income from the discharge of a partnership debt is therefore first allocated to each partner and tested *at the partner level* to determine whether the insolvency of a partner would require elimination of that item in the determination of the partner's individual tax obligations. An initial basis adjustment is therefore made under Section 702(a) to reflect the allocation of the debt discharge item to the individual partner; that adjustment is then offset by a reduction of basis under Section 733 and 752(b) to reflect the reduction in the partner's liability for partnership debts. If the partner's insolvency precludes recognition of the discharged debt as an item of income, that is to be treated separately on the partner's return and does not affect the calculation of the partner's basis in the partnership. 1997 WL 592925 (IRS TAM 97-39-002) at 2-3. These partnership adjustments made at the partner level under 26 U.S.C. 705 (see 26 U.S.C. 108(d)(6)) obviously have no direct relevance for application of the statutory provisions involved in this case, which require that the treatment of discharged debt of insolvent Subchapter S corporations be determined "at the corporate level" (26 U.S.C. 108(d)(7)) and that provide basis adjustments for any resulting item of "income" under 26 U.S.C. 1336 and 1367. Under the partnership rules and the Subchapter S rules, however, the final result will be the same: a debt discharge for an insolvent partner or for an insolvent Subchapter S corporation does not ultimately constitute an item of income *for the partners or for the*

2. The assertion that the amount of a discharged debt of an insolvent Subchapter S corporation flows through to the shareholders and allows them to claim deductions for otherwise nondeductible losses is also flatly inconsistent with the requirements of Section 108(d)(7). That Section specifies that the amount of the discharged debt of an insolvent Subchapter S corporation is to be applied, "at the corporate level," to reduce the favorable tax attributes of the corporation. 26 U.S.C. 108(d)(7)(A). Those attributes are defined to include, *inter alia*, the "net operating losses" of the corporation for the taxable year of the discharge (26 U.S.C. 108(b)(2)(A)) which, in turn, are defined to include any "suspended" losses that the shareholders were unable to deduct for that year because they had previously exhausted their basis under Section 1366(d)(1). See 26 U.S.C. 108(d)(7)(B); note 10, *supra*.

The obvious intent of these provisions—an intent that their language plainly supports—is that the amount of the discharged debt is to be applied to reduce or eliminate the shareholders' suspended losses and does *not* pass through to the shareholders to enable them instead to deduct those same losses. As Congress emphasized in 1993 in extending these provisions to "qualified real property" loans (26 U.S.C. 108(a)(1)(D)), Section 108(d)(7) requires the amount of the discharged indebtedness to be applied to reduce favorable tax attributes "at the S corporation level" and "[t]he shareholders' basis in their stock is *not* adjusted" by that amount. H.R. Rep. No. 111, *supra*, at 624-625 (emphasis added). See also *Gaudiano* v. *Commissioner*, No. 99-1294, 2000 WL 748179, at *18-*19 (6th Cir. June 8,

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shareholders and does not ultimately yield an increased basis for the amount of the discharged debt.

2000); *Witzel* v. *Commissioner*, 200 F.3d 496, 497-498 (7th Cir. 2000), petition for cert. pending, No. 99-1693.[19] In short, a pass-through of the amount of the discharged debt to the shareholders is logically incompatible with the statutory requirement that that same amount be utilized "at the corporate level" to reduce favorable corporate tax attributes. 26 U.S.C. 108(d)(7)(A).

In particular, petitioners' interpretation of the statute would nullify the mandate of Sections 108(b)(2)(A) and 108(d)(7)(B) that the amount of the discharged debt of an insolvent S corporation be used to reduce the shareholders' "suspended" losses "for the taxable year of the discharge." 26 U.S.C. 108(d)(7)(B). See note 10,

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[19] In *Gaudiano* and *Witzel*, the Sixth and Seventh Circuits agreed with the Tenth Circuit in this case that the amount of the discharged indebtedness of the insolvent Subchapter S corporation remains "at the corporate level" and eliminates suspended shareholder losses for the taxable year of the discharge at that level. See Pet. App. 16-17 n.6, Examples 1 and 3. In those cases, however, the Sixth and Seventh Circuits went on to state that any amount of this discharged debt that remained *after* the elimination of the shareholders' suspended losses passes through to the shareholders and increases stock basis. *Gaudiano*, 2000 WL 748179, at *19-*20; *Witzel*, 200 F.3d at 497-498. As we have explained (pages 10-13, *supra*), the conclusion that a debt discharge amount that is *not* applied against the tax attributes of an insolvent Subchapter S corporation would then flow through to the shareholders as an "item of income" under Section 1366 (and thereby increase the basis of their stock under Section 1367) is based on a misconception of what "income" represents. As the language of Section 108 indicates, and as the legislative history of the Bankruptcy Tax Act of 1980 expressly states, any amount of the discharged debt of the insolvent corporation remaining after application against the suspended losses "does not result in income or have other tax consequences" and is therefore to be "disregarded." S. Rep. No. 1035, *supra*, at 2.

supra. As the Sixth Circuit correctly recognized in *Gaudiano* v. *Commissioner*, 2000 WL 748179 at *17, *18-*19, if the amount of the debt discharge were treated as an "item of income" that flowed through to the shareholders of an insolvent Subchapter S corporation under Section 1366 in the manner suggested by petitioners, "the mandated reduction of the corporation's net operating losses (which include suspended shareholder losses) would never occur since there would be no [discharged debt amount] left at the corporate level to apply against the losses." Under petitioners' interpretation of these provisions, the statutory requirement that the discharged debt amount be applied to reduce the "suspended" shareholder losses for the taxable year of the discharge could not be fulfilled. *Id.* at *28.

The facts of the present case illustrate this point. The discharge of indebtedness of the Subchapter S corporation occurred in 1991. Prior to that year, petitioners each had several hundred thousand dollars in nondeductible "suspended" losses. During 1991, the Subchapter S corporation incurred additional losses; absent an increase in shareholder stock basis, these would be "suspended" losses that could not have been deducted in "the taxable year of the discharge" (26 U.S.C. 108(d)(7)(B)). Those "suspended" losses are specifically included on the list of favorable tax attributes that Congress specified are to be reduced by the amount of the discharged debt. *Ibid.*; see note 10, *supra*. Under petitioners' reasoning, however, the discharged debt amount would *not* be used to reduce or eliminate these losses, as Congress directed, but would instead be employed to generate additional stock basis that would permit petitioners to *deduct* these very same losses. As the court concluded in this case, "[t]o

embrace the taxpayers' position is to effectively eliminate the 'price'" of tax attribute reduction that Congress imposed when it endorsed the principle that debt forgiveness for insolvent corporations does "not" constitute an item of "income" in enacting Section 108. Pet. App. 13. By depriving the tax attribution reduction requirements of Section 108(d)(7)(B) of plausible meaning, the position advocated by petitioners violates the fundamental principle that "a statute must, if possible, be construed in such fashion that every word has some operative effect." *United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 36 (1992).[20]

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[20] Petitioners do not dispute that, under their approach, the reduction or elimination of suspended shareholder losses required by Section 108(d)(7)(B) can not occur whenever the debt discharge amount exceeds the amount of the suspended losses. They argue, however, that a reduction could occur in a situation where the debt discharge amount is *less* than the suspended losses (Pet. Br. 34-35). For example, if an insolvent S corporation is discharged from $100 in debt, and its shareholder has $200 in suspended losses, petitioners suggest that the debt discharge amount flows through to the shareholder, allows him to deduct $100 in losses, and then (magically) reappears at the corporate level to eliminate the *other* $100 in suspended losses. As the Sixth Circuit explained in *Gaudiano* v. *Commissioner*, *supra*, however, if the debt discharge amount passes through to and is used by the shareholder, there would be nothing left *at the corporate level* to apply against any remaining losses. See 2000 WL 748179, at *18-*19.

Even viewed in isolation from the applicable statutory text, petitioners' argument is patently illogical, for it would create an inverse relationship between the amount of indebtedness discharged and the amount of the tax attribute reduction that would occur. Under petitioners' approach, as the debt discharge amount increases, the shareholder would be able to deduct more suspended losses at the shareholder level and, as a result, the net operating loss reduction that occurs at the corporate level would be reduced.

3. The notion that the amount excluded under Section 108(a) constitutes an "item of income" that passes through the insolvent corporation to its shareholders under Section 1366(a)(1)(A) and increases shareholder stock basis in the corporation under Section 1367(a)(1)(A) is further refuted by reading Section 108(d)(7)(A) in conjunction with Section 1366(b). Section 108(d)(7)(A) provides that the debt discharge provisions for Subchapter S corporations are to be applied "at the corporate level." 26 U.S.C. 108(d)(7)(A). Section 1366(b) in turn provides that the character of an item to be passed through under Section 1366(a)(1)(A) is to be determined as if the item "were realized directly from the source from which realized by the corporation." 26 U.S.C. 1366(b). As the Tax Court explained in *Nelson* v. *Commissioner*, 110 T.C. at 122, the amount of the discharged debt, which is captured and applied "at the corporate level," cannot be treated as if it were obtained by the shareholders "directly from the source" and thus can "not pass through to the shareholders" under Section 1366. The concurring opinion of Judge Beghe in *Nelson* made the same point (110 T.C. at 131-132 (footnote omitted)):

> Section 1366(b) refutes [Nelson's] passthrough interpretation of section 108(d)(7)(A). There's no way, actually or fictively, in which the equivalence rule of section 1366(b) could apply to a solvent shareholder of an insolvent S corporation.[]

As Judge Beghe explained, since Section 108(d)(7)(A) "dictates" that the debt discharge amount be determined and applied "at the corporate level" rather than

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That absurd result would turn the tax-attribute reduction scheme enacted by Congress in Section 108 on its head.

at the shareholder level, the amount of that discharge can not "pass through to the shareholder under section 1366(a)(1)(A), and can't increase the basis of his stock under section 1367(a)(1)(A)." 110 T.C. at 134. See also Blanchard, *Debunking a Shibboleth*, 58 Tax Notes 1673 (1993).

4. Petitioners rely primarily on the decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198 (2000) (Pet. App. 92-124), petition for cert. pending, No. 99-1675, which held that the amount of discharged debt of an insolvent Subchapter S corporation passes through to the shareholders as an item of "income," thereby increasing their basis in the corporate stock and allowing them to deduct otherwise nondeductible suspended losses.[21] In reaching that conclusion, the Third Circuit did not dispute that the taxpayer's position would result in "an apparent 'double tax bene-

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[21] Petitioners also cite (Br. 22-23 n.12, 24 n.13) various articles as support for their position. For the reasons we have described in detail, the articles that support petitioners have failed correctly to analyze the text and history of these provisions. See pages 10-13, *supra*; 1 B. Bittker & L. Lokken, *supra*, at 7-58 (the debt discharge of an insolvent Subchapter S corporation is applied against the tax attributes of the corporation and "the unabsorbed amount is not gross income and is ignored"). The cited articles do not, in any event, provide an unqualified endorsement of petitioners' contentions. For example, one of the articles acknowledges that the Commissioner's position is in "compliance with the literal language of Section 108(d)(7)(A)" and states that "[t]he problem with the taxpayer's position [is] that he want[s] something for nothing." Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. Tax'n 272, 277 (1998). Another article observes that the government's position "is probably correct in its results from an equitable standpoint." Williford, *Shareholder is Wrestled Down with a Full Nelson-Interplay of COD and S Corporation Rules*, 39 Tax Mgmt. Memo. 247, 257 (1998).

fit'" for the Subchapter S corporation's shareholders. 202 F.3d at 209. The court also acknowledged that there was strong evidence that the position argued by the taxpayer "may not have been the result intended by Congress." *Id.* at 212 n.10. The court nonetheless concluded that "the clear and unambiguous language" of Section 1366(a) required it to rule in the taxpayer's favor because, under that provision, "all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation" and thereby "increases the shareholder's basis in their [S corporation] stock." *Id.* at 209, 210.

In so holding, however, the Third Circuit failed to give effect to the plain language of Section 108(a) which incorporates the longstanding rule that the discharge of indebtedness of an insolvent corporation does "not" represent "income" because it effects no gain or accretion of wealth for the taxpayer. 26 U.S.C. 108(a)(1)(B). See pages 10-13, *supra*. The court also failed to acknowledge the role of Sections 108(b) and 108(d)(7)(A), which require the amount of the discharged debt to be applied, "at the corporate level," to reduce the favorable tax attributes of the insolvent corporation (see note 10, *supra*) and that any "remaining debt discharge amount" is then to be "disregarded" for it "does not result in income or have other tax consequences." S. Rep. No. 1035, *supra*, at 2.

In particular, the decision of the Third Circuit in *Farley* would nullify the statutory mandate that the amount of the discharged debt of an insolvent corporation be applied "at the corporate level" to reduce or eliminate the shareholder suspended losses for "the taxable year of the discharge." 26 U.S.C. 108(d)(7)(A),(B). The court acknowledged in *Farley* that Section 108(d)(7)(B) specifies that the suspended losses that

accrue in the year of the discharge of indebtedness are to be treated as part of the "net operating losses" of the Subchapter S corporation. The court erred, however, in stating that this statute does not "indicate" that the amount of discharged debt "should *reduce* such net operating losses '*for the taxable year of discharge.*'" 202 F.3d at 207. The statute, in fact, *expressly* imposes that requirement by specifying, in Section 108(b)(2)(A), that the amount of the discharge of indebtedness is to be applied to reduce "[a]ny net operating loss for the taxable year of the discharge." 26 U.S.C. 108(b)(2)(A).[22] As other courts have noted, by interpreting the statute to pass the debt discharge amount through to the shareholders under Section 1366, the decision in *Farley* would allow the shareholders to deduct the very same "suspended" losses that the statute instead directs are to be reduced (or eliminated) "at the corporate level" under Section 108(b). *Witzel* v. *Commissioner*, 200 F.3d at 497; *Gaudiano* v. *Commissioner*, 2000 WL 748179, at *18-*19; pages 27-29, *supra*.

Perhaps recognizing that its decision would allow suspended losses in the year of the discharge to escape the attribute reduction required by Congress in Section 108(b), the Third Circuit suggested that "the tax attribute reduction scheme set forth in Section 108(a)-(b)" can instead be "implemented by reducing" *other* tax attributes listed in Section 108(b), such as "the basis of an S corporation's assets." 202 F.3d at 207-208. The

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[22] It is, of course, implausible that Congress would have taken the trouble to define Subchapter S corporation "net operating losses" for purposes of Section 108(b)(2)(A) to include the "suspended" losses incurred by shareholders in the year of the discharge (26 U.S.C. 108(d)(7)(B)) if Congress believed that those losses were, as the court held in *Farley*, never to be reduced.

possibility that the court's holding in *Farley* would not nullify *all* parts of the tax attribution reduction scheme of the statute, however, plainly does not justify the court's nullification of Section 108(d)(7)(B).

Moreover, the Third Circuit's reasoning ignores the express ordering provisions that Congress adopted for application of the tax attribute reduction scheme. Congress specified in Section 108(b) that (absent a specific election by the taxpayer) the amount of the discharged debt is to be applied *first* to reduce the net operating losses of the insolvent corporation (Section 108(b)(2)(A))—which expressly includes the "suspended" losses of the shareholders (Section 108(d)(7)(B))—and only *thereafter* is to be applied to reduce *other* tax attributes such as business credits or the basis of the assets held by the corporation. 26 U.S.C. 108(b)(2)(A)-(G).[23] See note 10, *supra*. The reasoning of the court in *Farley* is flatly inconsistent with this statutory directive that suspended losses in the year of the discharge be the *first* tax attribute reduced by the discharged debt under Section 108(b).

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[23] In describing these "ordering rules," Professors Bittker and Lokken state (1 B. Bittker & L. Lokken, *supra*, at 7-59):

> A bankrupt's or insolvent's debt discharge income is first subtracted from its net operating loss * * * for the taxable year in which the discharge occurs * * * . The theory underlying this reduction is as follows: By reason of the debt discharge, losses sustained by the taxpayer have been borne by the taxpayer's creditors. Normally, this would be reflected by requiring that the taxpayer recognize gross income in the year of the discharge to offset its earlier deductions of the shifted losses. However, because the losses have not yet yielded tax benefit, this rule simply shaves down the loss deductions to eliminate portions not ultimately borne by the taxpayer.

5. Petitioners further err in contending (Pet. Br. 35-41) that Section 108(b)(4)(A) of the Code supports their position in this case. Although the Tenth Circuit discussed that provision at some length in its opinion (Pet. App. 14-16), that statute has no bearing on the proper disposition of this case.

Section 108(b)(4)(A) provides a rule with respect to the timing of the attribute reductions mandated by Section 108(b). The statute provides that those reductions "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." 26 U.S.C. 108(b)(4)(A). In practice, this means that the amount of the discharged debt is not to be taken into account by an insolvent taxpayer, and results in no reduction of its tax attributes, until after the tax for the year of the discharge is determined.[24]

This requirement that the reduction in the insolvent taxpayer's tax attributes under Section 108(b)(4)(A) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge" (26 U.S.C. 108(b)(4)(A)) applies at the corporate level, not to petitioners as shareholders of the corporation. 26 U.S.C. 108(d)(7)(A). Nothing in Section

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[24] If the taxpayer elects under Section 108(b)(5) first to reduce its basis in depreciable property in lieu of reducing the attributes in the order prescribed by Section 108(b)(2) (see note 10, *supra*), the basis reduction takes effect under Section 1017 not "after the determination of the tax imposed * * * for the taxable year of the discharge" (26 U.S.C. 108(b)(4)), but, instead, "at the beginning of the taxable year following the taxable year in which the discharge occurs" (26 U.S.C. 1017(a)). The timing of the basis reduction in the event of this election was chosen "[in] order to avoid interaction between basis reduction and reduction of other attributes * * * ." H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980); S. Rep. No. 1035, *supra*, at 14.

108(b)(4)(A) addresses the question whether petitioners may take an amount that is "not" income under Section 108(a) and treat it as an "item[] of income" for the entirely different purposes of Section 1366. Instead, by deferring the attribute reduction under Section 108(b)(4)(A) until "after" the end of the tax period, the statute *ensures* that the amount of the discharged debt of the insolvent corporation will be used to reduce or eliminate the shareholder "suspended" losses "for the taxable year of the discharge" (Section 108(d)(7)(B)) and thereafter be applied to reduce other tax attributes of the corporation. See pages 27-29, *supra*.

Certainly, nothing in Section 108(b)(4)(A) can plausibly be said to be designed or intended to place any taxpayer in a *better* position than he would have been in had the discharge of indebtedness never occurred. As the Tenth Circuit observed in this case, "[t]o embrace [petitioners'] position is to effectively eliminate the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108." Pet. App. 13. The court of appeals correctly concluded that petitioners' effort to convert a statute that was enacted to *reduce* tax benefits into a provision that confers the "unwarranted windfall" of a double tax benefit is refuted by the text, purpose and history of these provisions. *Id.* at 16.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation which obtained a discharge of indebtedness. Income with respect to this cancellation of debt ("COD") was excluded from gross income under 26 U.S.C. § 108(a). The question presented in this case is whether excluded COD income is an item of income within the meaning of 26 U.S.C. § 1366(a)(1)(A), which increases Petitioners' basis in their S corporation stock pursuant to 26 U.S.C. § 1367.

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I. ARGUMENT

Tacitly recognizing that the rationale and statutory interpretations he advanced in the lower courts are not supportable, the Commissioner now abandons those positions altogether. In their place, he resurrects the "no income" argument rejected by the Tax Court in its first opinion in this case. The Commissioner fails to confront the Tax Court's holding that the "no income" argument relies upon a judicially crafted rule that was expressly eliminated with the enactment of § 108.[1]

The Commissioner attempts to bolster his "no income" position with the argument that Congress intended that shareholder losses, in all circumstances, be eliminated by the amount of COD. This argument ignores the controlling statutory provisions of §§ 108(d)(7)(B) and 1366(d)(1), which require that COD be taken into account in determining the suspended loss attribute subject to reduction. While the Commissioner argues that the Taxpayers' position will defeat attribute reduction entirely, it only places S corporation shareholders on par with all other taxpayers who have attributes and who are entitled to the full use of such attributes in determining taxable income for the year of the discharge.

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[1] All statutory citations, unless otherwise specified, refer to Title 26 (the Internal Revenue Code of 1986). Citations to Regulations or Treasury Regulations refer to 26 C.F.R.

A. The exclusion of any item of income, including COD, from gross income does not mean the item is not "income."

The central theme of the Commissioner's entire brief is that the amount of discharged debt excluded under § 108 is not income. *See* CMB:18.[2] This argument is squarely refuted by the plain language of §§ 61 and 108. "Gross income" is defined in § 61 to mean *all* income, from whatever source derived, including some fifteen listed items. Discharge of debt is one of the items listed. § 61(a)(12). Section 61(a)(12) draws no distinction between a solvent or insolvent debtor.

The inclusion of an item in gross income under § 61 means that the item will be used, first, in the determination of adjusted gross income, and, ultimately, in the determination of taxable income and tax. *See* §§ 62, 63, 1, and 11. MERTENS, JACOB, THE LAW OF FEDERAL INCOME TAXATION, §§ 5:01, 5:06. This is so unless an income item otherwise included within the reach of § 61 is specifically excluded from gross income by §§ 101 through 138. MERTENS, at § 5:06.

Sections 101 through 138 each contain the operative language "gross income does not include," then describe the item excluded. These exclusions prevent the item from being included in the computation of "gross income" and "taxable income." For that reason,

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[2] The abbreviation "CMB:xx is used to refer to the "Commissioner's Merits Brief" in this case. Similarly, the abbreviation "TMB:xx" is used to refer to the "Taxpayers' Merits Brief."

§ 1366(a)(1)(A) requires that "all items of income (including tax-exempt income)" be taken into account by an S corporation shareholder. In its first opinion in this case, the Tax Court concluded:

> Respondent would have us treat differently the operation of § 61(a)(12) and 108 and, for example, §§ 61(a)(4) and 103 (relating to interest) or § 61(a)(10) and 101 (relating to insurance). Respondent argues that, as an illustration, death benefits are first realized under § 61(a)(10) and then certain death benefits are excluded, i.e., not recognized, by § 101. Respondent argues that no such realization occurs in the case of discharge of indebtedness.
>
> Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, § 61(a)(12) requires that income from discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Section 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items of income excluded. Section 108(a)(1)(A), (3).
>
> Based on the foregoing, we hold that discharge of indebtedness is an 'item of income' for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under § 61(a)(12).

Winn v. Commissioner, T.C.M. (RIA) 97,286, App. 30, *withdrawn and reissued on other grounds as* T.C.M (RIA) 98,071, *aff'd sub nom, Gitlitz v. Commissioner*, 182 F.3d 1143 (10th

Cir. 1999). The Commissioner never addresses the Tax Court's conclusion in this regard.

The Commissioner implies that the Tenth Circuit opinion in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), concluded that income excluded under § 108 is not income. He states "The Court noted that a discharge of indebtedness does not constitute an item of income under § 108(a) if 'the debt is discharged in a bankruptcy proceeding or at a time when the debtor is insolvent . . . ' " CMB:6. Contrary to the Commissioner's selective quotation, the Tenth Circuit actually said that, under § 61(a)(12), the taxpayer whose debt is discharged generally has to recognize *taxable* income to the extent of the discharge. The *Gitlitz* court continued, "Section 108(a)(1) provides an exception to this rule, if, *inter alia*, the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent." *Gitlitz*, 182 F.3d at 1147. Thus, the Tenth Circuit concluded that the § 108 exclusion provides an exception to the rule that discharged debt is to be included *in taxable income*, not that § 108 eliminates debt discharge as an item of income. Indeed, the Court expressly held that excluded COD income *is* an item of income that "must pass through to shareholders unless [it is] absorbed by attribute reduction." *Gitlitz*, 182 F.3d at 1148.[3]

Every other court to examine the issue has agreed that COD income is an item of income under § 1366.

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[3] The Tax Court in *Nelson* likewise reasoned that "COD income" is excluded from the gross income of an S corporation at the corporate level. *Nelson v. Commissioner*, 110 T.C. 114, 121 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999).

United States v. Farley, 202 F.3d 198 (3d Cir. 2000); *Pugh v. Commissioner,* 213 F.3d 1324 (11th Cir. 2000); *Hogue v. United States,* 2000 WL 2651, 85 A.F.T.R.2d 2000-426 (D.Ore. 2000); *Gaudiano v. Commissioner,* 216 F.3d 524 (6th Cir. 2000); *Witzel v. Commissioner,* 200 F.3d 496 (7th Cir. 2000). *See* CMB:28 n.19.

B. Debt discharge results in realization of income, whether the debtor is solvent or insolvent. The pre-§ 108 judicial insolvency exception was expressly discarded with the enactment of § 108.

The Commissioner argues broadly that no income is *realized* as a result of an insolvent debtor's discharge from liability. For this sweeping proposition, he relies upon a 1923 Treasury Ruling, cases from the 1930s and 1940s, and a 1957 Treasury Regulation (§ 1.61-12(b)(1)). He argues that "In 1980 Congress embraced and codified this well established 'insolvency exception' by specifying in § 108(a) of the Code that the discharge of debt does 'not' constitute an item of 'income' to an insolvent taxpayer." CMB:13.

The statutory language of § 108(a) undermines the Commissioner's argument. It states, in part, "Gross income does not include any amount which (*but for this subsection*) would be included in gross income" by reason of discharge of indebtedness if the taxpayer is insolvent. § 108(a)(1)(B). (Emphasis supplied.) Section 108 only excludes items that are otherwise included in gross income. *See* SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.03[3][a][i], 6-77, 78 (Matthew Bender. 1999).

If, as the Commissioner argues, debt discharge of an insolvent debtor were not income, then it would not be excluded under § 108(a). Because the attribute reduction rules of § 108(b) apply *only* to amounts excluded by § 108(a), the discharge of indebtedness of an insolvent debtor would never result in attribute reduction – this is contrary to the statute and common sense.

Section 108(e)(1), moreover, provides that "Except as otherwise provided in [§ 108], there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness." In its initial decision, the Tax Court concluded:

> Section 1.61-12(b) restates the pre-Section 108 judicially created insolvency exception. Section 108 codified the insolvency exception as an exclusion from gross income. Section 108(e)(1) provides that 'There shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness', except as provided in § 108. Thus, § 108, not § 1.61-12(b) controls these cases. (internal citations eliminated)

Winn, T.C.M. (RIA) 97,286, App. 29. A well-respected treatise describes the relation between § 108 and prior law as follows:

> These rules, which were enacted in 1980, are exclusive and supercede earlier rules developed by the Courts and the IRS. § 108(e)(1). Under prior law, an insolvent or bankrupt taxpayer

> realized no income on a discharge of indebtedness and suffered no reduction in any tax attribute. . . . [4]

BITTKER, B. & LOKKEN, L., FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶6.46, at 6-58 n.97 (2d Ed. 1989). Thus, § 108 leaves no doubt that the pre-1980 cases, rulings, and Treasury Regulation upon which the Commissioner relies have no application with respect to income subject to § 108.[5]

The judicial insolvency exception should not play any part in this Court's consideration. As discussed extensively in *Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991), the rule was based upon the notion that relief of debt should be taxed only if it results in a "freeing of assets" or "accession to wealth." Perhaps because of a depression-era reluctance to "kick someone when he is down," a rationale was formulated to avoid taxing a debtor who remained insolvent after debt relief. *Newman*, 934 F.2d at 431.

The judicial exception is not analytically supportable, particularly when it is recognized that cash income to an insolvent debtor remains taxable, even if the debtor used the cash to reduce the burden of debt, and even though

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[4] The Commissioner inexplicably cites this same section of Bittker & Lokken in support of his argument that the judicial insolvency exception remains good law. CMB:12.

[5] When it enacted § 108 in 1980, Congress specifically noted that "income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income." S. Rep. No. 1035, 96th Cong., 2d Sess. 44 (1980), 1980 U.S.C.C.A.N. 7017, 7058. Thus, it is clear that Congress considered excluded COD as "income."

the debtor's assets are no more "freed up" than in the case of forgiveness of debt. *Newman*, 934 F.2d at 432. A debtor whose debt is discharged has in fact realized an economic benefit, even if he remains insolvent after the discharge, e.g., a debtor whose assets are $90,000 and whose debts are $200,000 certainly realizes an "accession to wealth" if $100,000 of his debts are discharged, despite remaining insolvent.

As the *Newman* court pointed out, citing to this Court's decision in *United States v. Centennial Savings Bank*, 499 U.S. 573, 581-582 (1991), borrowed funds are not considered income when obtained because the obligation to repay offsets the increase in assets. If the obligation to repay is extinguished, "the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates." *See also Tufts v. Commissioner*, 461 U.S. 300, 310 n.11 (1983); SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.02[2][a], 6-7 – 6-11 (Matthew Bender. 1999). The *Newman* Court concluded that the judicial insolvency rule was an "illogical exception" to the general rule, announced in *United States v. Kirby Lumber*, 284 U.S. 1 (1931), that debt relief is income. *Newman*, 934 F.2d at 432.[6]

The judicial insolvency exception amounted to the courts (with the acquiescence of Treasury) fashioning a de

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[6] As the taxable year at issue in *Newman* was prior to the effective date of § 108, the Commissioner "concede[d] to history" ("not without understandable complaint") and agreed that the rule applied. *Newman*, 934 F.2d at 432.

facto exclusion from gross income. However, only Congress can legitimately create exclusions. Congress rectified that situation and made the exception obsolete when it enacted the modern version of § 108.

In a further effort to support his "no income" argument, the Commissioner cites to the Senate Report relating to the enactment of § 108 (S. Rep. No. 1035, 96th Cong., 2d Sess. (1980) 2, 13) and a treatise (BITTKER, B. & LOKKEN, L., FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶7.6.3, 7-58 (3d Ed. 1999)), stating that any amount of debt discharged remaining after application against tax attributes is to be disregarded and "does not result in income or have other tax consequences."[7] CMB:15.

What the Commissioner fails to recognize is that attribute reduction takes place *after* the determination of tax for the taxable year of discharge. In the case of shareholder suspended losses, attribute reduction takes place *after* the passthrough of COD income has occurred and the loss in excess of basis has been determined under §§ 108(d)(7)(B), 1366(d)(1), and 1367(a). Once the current year's tax and the surviving tax attributes have been determined, the only remaining consequence of COD income is reduction in the attributes as of the beginning of the next taxable year. Thereafter, the item can indeed

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[7] By indicating the new attribute reduction rules were exclusive, the Senate acted to eliminate the various prior law modifications of tax status under the judicially created insolvency exception. For example, the Senate specifically intended to overturn the IRS policy of treating basis reductions in Investment Tax Credit property as dispositions, subject to recapture tax. S. Rep. No. 1035, 96th Cong., 2d Sess. 9 (1980), 1980 U.S.C.C.A.N. 7017, 7024.

be ignored.[8] Thus, the Senate Report, stating that income remaining *after* attribute reduction does not have further consequences, is consistent with Taxpayer's position: basis was adjusted *prior* to the time of attribute reduction.

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[8] The Commissioner also argues that the legislative history of the 1993 amendment to § 108 supports his position that there are no basis effects for excluded COD income, citing H.R. Rep. No. 111, 103d Cong., 1st Sess. 622 (1993). The amendment in question did not alter existing law as to the relationship between § 108 income and shareholder basis adjustments, but created a new elective exclusion of COD income for *solvent* taxpayers, conditioned upon a reduced basis in encumbered property. New § 108(a)(1)(D). The 1993 legislative history relates to the new § 108(a)(1)(D), and cannot be read to extend to other provisions of § 108. Moreover, a reduction in property basis may require a reduction in shareholder basis under § 1367(a)(2)(D). *See* § 1.1502-32(b)(3)(iii)(B) (treating § 1017 basis reductions as a "noncapital, nondeductible expense" under a consolidated return regulation that parallels § 1367(a)(2)(D)); *see also* § 50(c)(5). Even if it were read in the manner suggested by the Commissioner, the explanation by the 1993 Congress *11 years* after the Subchapter S Revision Act of 1982 (which enacted §§ 1366 and 1367 in their current form), provides no indication of legislative intent and understanding at the time that the controlling basis provisions of Subchapter S were enacted. *See Bufferd v. Commissioner*, 506 U.S. 523, 530 n.10 (1993). We note that this matter was addressed in "legislative history" shortly after the ABA Tax Section brought this matter to the attention of Treasury. Witt, Fred T., Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Tax Force*, 46 Tax Law 209 (1992).

C. The Commissioner provides no principled reason for denying a basis increase for COD income, but permitting it for other items of non-taxable income.

Recognizing that all other items of income increase stock basis pursuant to §§ 1366 and 1367, the Commissioner struggles to offer a plausible rationale for denying COD income the same treatment.[9] The Commissioner

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[9] All items excluded from tax by statute should be accorded equal treatment under § 1366(a)(1)(A). Significantly, the Commissioner construed the phrase "including income exempt from tax" to include excluded COD income under § 108. Tech. Adv. Mem. 97-39-002 (construing § 705(a)(1)(B) – the partnership analogue of § 1366(a)(1)(A)). The Commissioner argues that for partnerships, this is a matter of no consequence because, simultaneous with the basis increase for partnership exempt income, there is an equivalent basis reduction under § 752. CMB:26 n.18. The Commissioner has not considered the implications of this argument. Essentially, he is arguing that partnerships should be treated better than S corporations. (In *Witzel*, Judge Posner noted that the Commissioner was seeking to impose a rule similar to § 752 on S corporation shareholders, but that he lacked a statutory basis for doing so. *Witzel*, 200 F.3d at 498.) Consider the case where an entity, S corporation or partnership, borrows money to fund a business venture, the venture fails, the entity and its owners are insolvent, and the lender forgives the debt. The partner was able to increase his basis by his pro rata share of the liability – the S corporation shareholder was not. When the losses were generated, the partner could deduct them up to the amount of basis – the S corporation shareholder did not have sufficient basis and her losses were suspended. When the partnership's liability was discharged, the insolvent partner's basis was increased by his share of the discharged liability under § 705(a)(1)(B), then decreased an equal amount under § 752, resulting in a zero basis. When the S corporation's liability was discharged, under

argues that, in contrast to a corporation's collection of life insurance proceeds or non-taxable bond interest, the insolvent corporation which is discharged from debt "acquires no asset for distribution in cash or in kind to its shareholders" and has "a reduction or extinguishment of liabilities without any increase in assets." CMB:23.

This argument relies upon an overly simplistic notion of "economic wealth" – it only takes into account increases to the asset side of the ledger and ignores decreases to liabilities. It assumes that cash proceeds representing exempt income will actually be collected by the corporation. In the case of zero coupon municipal bonds, this may not happen for years. Moreover, the cash collected may not be distributed to shareholders, but rather used to pay down debt, in which case the corporation is in exactly the same economic situation as if the debt itself were discharged. Accordingly, the bottom line

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the Commissioner's interpretation, the shareholder of the insolvent corporation is *not* able to increase her basis by her pro rata share of the discharge under §§ 1366 and 1367, and her losses are eliminated in attribute reduction. At the end of the day, while both have zero basis, the partner has obtained the benefit of business losses, but the S shareholder has not. The rule championed by the Taxpayers provides a rough equivalence of treatment between shareholders in insolvent S corporations and insolvent partners. Both obtain the benefit of the losses (the partner when the losses are incurred and the shareholder in the year of the discharge), and end up with a zero basis. Far from seeking benefits in excess of that accorded partners, the Taxpayers merely seek rough equivalence between the two types of passthrough entity.

balance sheet effect of debt discharge cannot be meaningfully distinguished from other types of non-taxable income. TMB:48-49.

Finally, the same rationale for increasing stock basis by the amount of non-taxable items of income applies with equal force in the case of COD income. TMB:48. If an increase to stock basis is not made to reflect the corporation's realization of COD income, then, if there is a distribution to the shareholders in the future, the amount of the debt discharge and the corresponding increase in net equity will be subject to tax, just as the amount of non-taxable bond interest would be subject to tax if no upward adjustment to basis were made. The Commissioner responds to this argument by retreating to the judicial insolvency rationale:

> [T]he treatment sought by Petitioners for debt discharge of an insolvent taxpayer would create an addition to basis (and thereby permit additional deductions) for which no offsetting item of 'income' exists.

CMB:24 n.17. The answer to this argument is that an offsetting item of income does exist, as Congress has expressly recognized in §§ 61 and 108.

D. The Commissioner disregards the language of the Treasury Regulation governing S corporation shareholders' adjustments to basis.

The Treasury Regulation governing adjustment to shareholder basis (Treas. Reg. § 1.1367-1(d)(2)) broadly requires an adjustment to basis for any "non-taxable item" where the item would have been included in

income for the taxable year under the corporation's method of accounting, had it been taxable. TMB:18-19. If the COD income of an insolvent debtor were not excluded from gross income by § 108(a), then it would have been taxable under § 61(a)(12) for the year of the discharge. This regulation leaves no doubt that excluded COD income must be taken into account in the Taxpayers' basis computations.

Even though this regulation applies directly to the issue of what items increase shareholder basis, the Commissioner claims that the 1957 Treasury Regulation under § 61, § 1.61-12(b)(1), is the controlling authority. CMB:24-25. As discussed above, this regulation restates an outdated judicial rule and is "plainly inconsistent with the statute" as amended in 1980, and should not be followed. *Rowan Cos. v. United States,* 452 U.S. 247 (1981); *United States v. Cartwright,* 411 U.S. 546, 557 (1973).

E. The Commissioner has abandoned the rationale adopted by the Tenth Circuit in this case. His argument that § 108(d)(7) precludes excluded COD income from being passed through to shareholders ignores § 108(d)(7)(B).

While the timing rule of § 108(b)(4)(A) was the linchpin of the Tenth Circuit's opinion (*Gitlitz,* 182 F.3d at 1149), the Commissioner now concedes that § 108(b)(4)(A) "has no bearing on the proper disposition of this case," and agrees that § 108(b)(4)(A) defers attribute reduction until "after the end of the tax period." CMB:36-37. The Commissioner argues instead that § 108(b)(4)(A) applies at the corporate level, and not at the shareholder level. But § 108(b)(4)(A) applies to *all* tax

attributes affected under § 108(b); it makes no distinction between shareholders' suspended losses (treated as corporate NOLs for attribute reduction purposes) and other attributes.

The Commissioner argues that §§ 108(d)(7)(A) and (B) reflect an "obvious intent" that the amount of discharged debt is to be applied to reduce or eliminate the shareholders' suspended losses. Thus, he argues, such losses should *not* pass through to the shareholders to enable them to deduct those same losses. CMB:27-31. The Commissioner never confronts the critical language of § 108(d)(7)(B). The Commissioner claims that § 108(d)(7)(B) provides that "any loss" "for the taxable year of the discharge" is treated as an attribute subject to reduction. The detailed statutory language of § 108(d)(7)(B), however, provides that only the shareholders' "loss disallowed for the taxable year of the discharge under § 1366(d)(1)" is treated as a corporate NOL for attribute reduction purposes.

This language means that *before* any shareholder loss can be treated as an NOL, there must be a determination as to the amount of the loss in excess of basis. § 1366(d)(1); TMB:33. In computing loss in excess of basis, § 1366(d)(1) requires that *all* items of income and loss for the current year, including those items of income for which a basis adjustment is required under § 1367(a), and those items of loss arising in a prior year and suspended under § 1366(d)(1), be taken into account. Any loss in excess of basis is carried forward to the next succeeding taxable year. § 1366(d)(2). It is only this "excess" that is subject to attribute reduction in place of an NOL. § 108(d)(7)(B).

As applied to the facts of this case, the rules of §§ 108(d)(7)(B), 1366(d)(1), 1366(a)(1)(A), and 1367(a) produce the following result: (1) the Taxpayers' suspended losses existing as of the end of 1990 are carried forward and treated as deductions in 1991; (2) a pro rata share of the S corporation loss for the 1991 year is taken into account by the Taxpayers; (3) a pro rata share of all items of S corporation income for the 1991 year is taken into account by the Taxpayers, including the excluded COD income, in order to determine stock basis for 1991; (4) the total loss is compared to adjusted stock basis, and to the extent that there is an excess, such excess is the amount disallowed under § 1366(d)(1) for the year; and (5) this disallowed amount is reduced by the amount of COD income in the attribute reduction process as of the beginning of the next succeeding taxable year. §§ 108(b)(2) and (b)(4)(A).

The Taxpayers' interpretation of §§ 108(b)(2) and 108(d)(7)(B) does not, as the Commissioner argues (CMB:29-30), eliminate the "price" Congress intended to impose upon the exclusion of COD from gross income under § 108. Congress specifically limited the price when it provided for attribute reduction only *after* determination of the tax liability for the year of discharge. This means that a debtor with an asset having a basis of $100,000 and a fair market value of $50,000, and who has COD income of $100,000, can sell the asset during the year of discharge and claim a $50,000 loss. If he sold the asset the following year, his basis would be reduced to zero and he would have $50,000 taxable gain. This time-sensitive tax benefit is specifically provided by the language of the statute. The statutes provide no basis for

treating the taxpayer with suspended losses any differently.[10]

The Taxpayers' position as to the proper treatment of shareholder suspended losses is consistent with § 108's treatment of a "C" corporation's NOLs. In the case of a "C" corporation, the excess of business deductions over business income creates a net operating loss deduction under § 172, which can be carried back to prior years and/or forward to subsequent taxable years, and used as a deduction to reduce taxable income in those years. But, because the current year's NOL is the amount that current year deductions exceed income, the NOL does not affect income and tax liability for the current year. Thus, its reduction by the amount of COD income, when required under the attribute reduction provisions of

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[10] The Taxpayers' interpretation of the statutes would preserve attribute reduction for shareholder losses whenever the losses exceed COD income. TMB:34-35. The Commissioner argues that this position means that the debt discharge amount first passes through to the shareholder for purposes of determining his allowable loss for the taxable year of the discharge, then "magically reappears" at the corporate level to eliminate the remaining loss. CMB:30 n.20. The magic is in the statute: § 108(d)(7)(B) requires, first, that *shareholder* loss in excess of basis, if any, be determined. If there is an excess, the subsection also provides it is to be treated as a corporate NOL subject to reduction at the corporate level under § 108(b)(2)(A). Nor does the Taxpayers' interpretation of the statutes lead to an "absurd result," as the Commissioner maintains. CMB:30 n.20. All losses in excess of the amount of COD income are eliminated, and the greater the shareholder's suspended loss in relation to the amount of debt discharge, the greater the loss subject to reduction.

§ 108(b)(2)(A), will never affect tax liability for the year of the discharge.[11]

Likewise, COD income does not reduce the amount of shareholder suspended losses which can be utilized *in the current year* (as opposed to future years). The attribute reduction required under § 108(b) only operates to reduce shareholder losses that survive the current year, and which, but for § 108, would be carried forward to subsequent years.

F. Section 1366(b) is not in conflict with the Taxpayers' position.

The Commissioner argues that, since excluded COD income is "captured and applied at the corporate level," it cannot be considered a passthrough item under § 1366(a) because to do so would conflict with the "character" rule of § 1366(b). CMB:31. The answer to this argument is that COD income is not "captured and applied at the corporate level" to the extent that §§ 108(d)(7)(B), 1366(a)(1)(A), and 1367(a) require that it be taken into account at the shareholder level. Further, § 1366(b) treats the item in the hands of a shareholder as if the shareholder, and not the S corporation, realized the

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[11] Since attribute reduction occurs after the determination of tax for the year of the discharge, an NOL carryforward *to* the year of the discharge can be used as a deduction during that year. SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶6.03[4][b][i] (Matthew Bender. 1999). This is consistent with Taxpayers' position that they can use their 1990 suspended losses in computing the 1991 "loss disallowed under § 1366(d)(1)."

item. For example, if an item of income is "long term capital gain" to the corporation, it is to the shareholder as well, irrespective of the fact that the shareholder held his S corporation stock for less than one year. Likewise, § 1366(b) permits a solvent shareholder to take excluded COD of the corporation into account (retaining its exempt character), even though the exclusion was conditioned upon the corporation's insolvency.[12]

II. SUMMARY AND CONCLUSION

The statutory mandate that all items of income be taken into account in computing shareholder basis, provided they could affect shareholder tax liability, could hardly be more clear – all means all. In an effort to avoid this unequivocal mandate, the Commissioner finds that he cannot embrace the rationale of any court's decision where he has previously prevailed. The Commissioner therefore retreats to a non-statutory rule that has been obsolete for 20 years, and urges an interpretation of § 108(d)(7)(B) that would deprive the Taxpayers of the benefits afforded all other insolvent taxpayers, who are

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[12] For similar reasons, the *Farley* court held that the Commissioner's argument that § 1366(b) supports his position is "flawed," stating:

> Section 1366(b) deals with the character of income which has been passed through to the shareholder, while § 108(d)(7)(A) deals with the application of indebtedness exclusion requirement and tax attribution scheme detailed in §§ 108(a) through 108(b). These two statutory provisions address different issues at different levels.

Farley, 202 F.3d at 209.

permitted full use of their losses and other tax attributes in the year of discharge.

Submitted this 6th day of September, 2000.

Respectfully submitted,

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In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

BRIEF AMICUS CURIAE FOR THE REAL ESTATE ROUNDTABLE SUPPORTING PETITIONERS

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STATEMENT OF AMICUS INTEREST[1]

The Real Estate Roundtable (the "RER") is an organization comprised of the principals of the leading real estate companies and the heads of major real estate trade organizations. Its members are public and private real estate owners, advisors, builders, investors, lenders and managers. The RER provides a vehicle for its members to identify, develop, analyze and advocate federal policy positions.

The RER writes to urge the Court to reverse the decision of the Tenth Circuit concerning the tax treatment of cancellation of indebtedness (COD) income by an insolvent or bankrupt S corporation. Although the decision directly affects only a handful of the members of the RER (because most real estate is not owned through S corporations), the Tenth Circuit's erroneous interpretation and application of Section 108(b)(4)(A)[2] could have wide-ranging impact on the real estate industry.

Furthermore, the real estate industry is significantly affected by the tax laws, so that certainty as to application of the Code is essential. The Tenth Circuit's decision, which is contrary to the plain meaning of the Code, appears to be a strained attempt to re-write the statute to obtain what the court believes is the "right" result. The

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[1] The parties have consented to the filing of this brief. Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members or its counsel, made a monetary contribution to the preparation and submission of this brief.

[2] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended ("Code").

courts should not substitute their judgment for that of Congress; if the Code needs to be changed, Congress (and not the courts) should fix it. Accordingly, the RER urges the Court to adopt the analysis set forth by the Third and Eleventh Circuits in *U.S. v. Farley*, 202 F.3d 198 (3rd Cir. 2000), and *Pugh v. Commissioner*, No. 99-12646, 2000 U.S. App. LEXIS 12200 (11th Cir. 2000), respectively.

SUMMARY OF ARGUMENT

1. Section 108(b) of the Code provides for the reduction of tax attributes as a result of the exclusion of COD income under Section 108(a). Section 108(b)(4)(A) provides an essential "ordering" rule concerning the timing of attribute reduction. Under this provision, tax attributes are reduced *after* the determination of the tax liability for the year of the discharge of indebtedness. The Tenth Circuit disregarded this rule, reducing tax attributes *as part of* the determination of the tax liability for the year of the discharge of indebtedness.[3] There is no basis for the Tenth Circuit's application of this rule.

This timing rule is a critical element of every debt workout or restructuring. The ordering rule furthers sound tax and economic policies which should not be lightly brushed aside. Moreover, the Tenth Circuit's interpretation of this rule could have an impact far beyond the

[3] *See Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999).

narrow question concerning the interaction of the rules involving COD income and S corporations currently before the Court.

2. The Code provides clear rules concerning the treatment of excluded COD income by an insolvent or bankrupt S corporation. The Tax Court in *Nelson v. Commissioner*, 110 T.C. 114 (1998), made a strained interpretation of the law in order to avoid a result that the Tax Court believed resulted in an unwarranted benefit to the taxpayer. But to do so, the Tax Court had to ignore the plain meaning of the Code.

No circuit court has agreed with the *Nelson* rationale because *Nelson* cannot be reconciled with the Code. Nonetheless, three circuit courts have held for the IRS. These courts have all explicitly recognized that theirs were result-oriented decisions, which were aimed at achieving the "right" result, even if the Code does not support their conclusions.

Taxpayers need certainty in the tax law, particularly when the law is clear. The tax law is written by Congress, not the courts. In this case, the clear language of the Code requires a decision in favor of the taxpayer, as two circuit courts have recognized in *Farley* and *Pugh*. The Court should reverse the decision of the Tenth Circuit for the reasons set forth by the Third and Eleventh Circuits.

BACKGROUND

The tax law is often obscure and confusing; the courts have frequently said as much.[4] That is not the problem in this case, however. In the case of COD income realized by an insolvent or bankrupt S corporation, the Code is clear. Although various sections of the Code are involved, the statutory path is a bright one, and all the provisions interact in a seamless web that results in predictable tax consequences.

S Corporations. S corporations are a creature of the Code, with special pass-through treatment ordained by Sections 1363, 1366 and 1367. Under Section 1363(a), an S corporation is not subject to income tax. Instead, Section 1366(a)(1)(A) provides that the shareholder of an S corporation is required, in determining his or her income tax liability, to take into account the shareholder's pro rata share of the S corporation's:

> items of income (including tax-exempt income), loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder.

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[4] Judge Learned Hand once commented, "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." *The Spirit of Liberty: Papers and Addresses of Learned Hand* (Irving Dillard ed., 2d ed., 1953) 213.

Distributions by an S corporation to a shareholder are taxable to the extent that the distributions exceed the shareholder's stock basis.[5] Section 1367(a) provides a basis increase for every item described in Section 1366(a)(1)(A), *i.e.*, all items of income (including tax-exempt income). Thus, for example, if an S corporation receives interest on tax-exempt bonds (Section 103) or the proceeds of a life-insurance policy (Section 101), the shareholder's basis in the S corporation is increased by the amount of tax-exempt income.

Basis is also important to a shareholder of an S corporation in determining the amount of losses the shareholder can utilize. Under Section 1366(d), a shareholder of an S corporation may not utilize losses in excess of his or her basis in the stock of the S corporation; every dollar of loss utilized is treated as a distribution to the shareholder, reducing his or her stock basis.

COD Income. Subchapter B of Chapter 1 of the Code addresses the computation of taxable income of a taxpayer. Part I of Subchapter B, which is the definition of gross income, includes Section 61(a)(12), which sets forth the general rule that COD income is included in taxable income. Part III of Subchapter B, entitled "Items Specifically Excluded from Gross Income," contains 31 sections, each specifically providing an exclusion from gross income. Section 108 provides for the exclusion of COD income in certain situations.

Under Section 108(a), gross income does not include any amount which would otherwise be includible in

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[5] Section 1368.

gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent or in a Title 11 bankruptcy case. The "price" for this discharge is that a taxpayer is required to reduce tax attributes (such as net operating loss carryovers, capital loss carryovers, the basis of assets and passive loss carryovers) by the amount of COD income that has been excluded.[6] This attribute reduction is made, pursuant to Section 108(b)(4)(A), after the determination of the tax imposed on the taxpayer for the taxable year of the discharge.

The ordering rule in Section 108(b)(4)(A) is important because it allows an insolvent or bankrupt taxpayer to fully utilize any tax attributes to offset any taxable income for the current year before reducing such attributes as a result of the exclusion of COD income. Thus, for example, if an insolvent individual has $100 of salary income, $150 of net operating loss carryovers ("NOLs") and $175 of COD income in 2000, the taxpayer would (i) exclude the COD income under Section 108(a), (ii) use $100 of the NOLs to offset his or her salary income in 2000, and then (iii) reduce his or her remaining tax attributes ($50 of NOLs) as a result of the exclusion of $175 of COD income.[7] The fact that the excluded COD income

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[6] Section 108(b).

[7] *See* S. Rep. No. 1035, 95th Cong. 2d Sess. 1, 13 n.13 (1980) ("These [attribute] reductions are made after the computation of the current year's tax.")

exceeded the taxpayer's tax attributes would have no further impact on the calculation of his tax liability.[8]

Special COD Rules for S Corporations. Congress addressed the interaction of Section 108 and Subchapter S corporations concisely in Section 108(d)(7). Specifically, Section 108(d)(7)(A) provides in relevant part that subsections 108(a) and 108(b) must be applied at the corporate level. Thus, in determining whether Section 108(a) applies to an S corporation, the solvency determination is made at the corporate (and not at the shareholder) level. This is the opposite of the rule for partnerships, in which the determination of solvency is made at the partner level.[9]

An S corporation does not have NOLs because an S corporation is not taxable on its income. However, losses of an S corporation can be suspended at the shareholder level (due to a lack of basis) under Section 1366(d). Section 108(d)(7)(B) coordinates the rules of Subchapter S with the attribute reduction rules in Section 108(b) by providing that for purposes of Section 108(b), any losses which are suspended under Section 1366(d) shall be treated as NOLs for the taxable year. The effect of this rule is to treat shareholder-level suspended losses as if they were corporate-level NOLs, which are then treated as attributes subject to reduction under the general rules in Section 108(b).

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[8] *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 1, 13 (1980) ("Any amount of debt discharge which is left after attribute reduction under these rules is disregarded, *i.e.*, does not result in income or have other tax consequences.")

[9] Section 108(d)(6).

The Litigation. The tax treatment of S corporations realizing COD income was not raised by the IRS until the debt workouts that occurred in the early 1990s. At that time, many S corporations became either insolvent or filed for bankruptcy.

In a typical case (such as *Gitlitz*), the S corporation had indebtedness that significantly exceeded the fair market value of its assets. Losses realized at the S corporation level exceeded the shareholder's basis in the stock of the S corporation; such excess losses were suspended at the shareholder level under Section 1366(d). When all or a portion of the indebtedness was forgiven by the lender, it was undisputed that the COD income was excluded under Section 108(a) due to the insolvency of the S corporation. The shareholders of the corporations claimed that the excluded COD income resulted in a basis increase and, to the extent the shareholders had suspended losses under Section 1366(d), this basis increase permitted the shareholders to use those losses in the year of discharge. Attribute reduction would not occur until after the determination of tax liability for the year of discharge, so the suspended losses were used before attribute reduction could take place.

The questions considered by the courts in the instant series of cases were (i) whether the excluded COD income "flowed through" to the shareholder, thereby resulting in a basis increase under Section 1367(a), and (ii) if it did, could the shareholder utilize losses suspended under Section 1366(d) during the year of the discharge (and before

such losses could be reduced under Section 108(b)).[10] The various courts have, in chronological order, used differing reasoning and reached disparate results:

Nelson. The Tax Court was the first court to face this issue.[11] In *Nelson*, the Tax Court concluded that Section 108(d)(7)(A) required that the exclusion of COD income be made at the corporate level. Because COD income was excluded at that level, the Tax Court concluded that there was no income to pass through to the shareholders of the corporation. The Tax Court further reasoned that because the COD income had been eliminated at the corporate level, it was not tax-exempt income that could flow through to increase the shareholder's basis. Because there was no basis increase, suspended losses could not be utilized but, instead, were attributes that were treated as NOLs and reduced pursuant to Section 108(d)(7)(B).

The Tax Court's decision rested on its erroneous interpretation of the phrase "applied at the corporate level" in Section 108(d)(7)(A). In the case of an S corporation, all calculations of income, gain, deduction, loss and credit are first made at the corporate level, with items

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[10] The COD income would cause a basis increase under Section 1367, which would remove the restriction on loss utilization under Section 1366(d). As a result, the taxpayer could use suspended losses to offset income from the year of discharge, or carry such losses back to offset income in a prior taxable year. Because the losses had been utilized, Section 108(b) would be inapplicable.

[11] In its first foray into this area, *Winn v. Commissioner*, 75 T.C.M. (CCH) 1840 (1998), the Tax Court granted summary judgment for the taxpayer; the Tax Court reversed *Winn* in *Nelson*.

then passing through to the shareholders of the S corporation. Likewise, limitations provided in the Code, such as the limitation on the deduction of hobby losses under Section 183, are first applied at the corporate level. The fact that calculations and limitations are first applied at the corporate level does not prevent a flow-through to the shareholders of the S corporation; Section 1366(a) mandates the opposite result. In the case of COD income, the insolvency determination made at the corporate level results in exclusion of the COD income, with the excluded COD income then flowing through to the corporation's shareholders under Section 1366(a).

Gitlitz. In *Gitlitz*, the Tenth Circuit affirmed *Nelson* on other grounds. The Tenth Circuit (as well as every other circuit court) expressly rejected the Tax Court's conclusion that COD income was not tax exempt income that passes through to the shareholders of the S corporation. Instead, to prevent losses being claimed by the shareholders, the Tenth Circuit concluded that attribute reduction under Section 108(b)(4)(A) occurs during the year that the debt is cancelled. The court accomplished its goal by using the suspended losses to offset the COD income. The result was that the suspended losses were eliminated, thereby preventing the taxpayers from claiming losses during the taxable year at issue. Offsetting the COD income by the suspended losses also prevented a basis increase to the shareholders.

The Tenth Circuit referred to the "absorption" of the COD income or to "offsetting" the COD income with tax attributes. This analysis misapplies the statutory scheme. Under Section 108(a), the COD income of an insolvent or bankrupt S corporation is excluded, without any "offset"

or "absorption." If the S corporation has any tax attributes remaining after the calculation of tax for the year of the discharge, such attributes are reduced (up to the amount of the COD income) under Section 108(b). If the S corporation has no tax attributes, however, the COD income is nonetheless excluded under Section 108(a). Thus, the exclusion of COD income is independent of the tax attribute reduction.

The Tenth Circuit apparently recognized that its decision could not be reconciled under the statutory language in Section 108(b)(4)(A), and that its decision could have an impact on situations not involving S corporations. Accordingly, the Tenth Circuit stated in dicta that its application of Section 108(b)(4)(A) was limited to determining the impact of COD income on S corporations. *See* 182 F.3d at 1151. However, there is absolutely no statutory support for this limitation; neither Section 108(b)(4)(A) nor Section 108(d)(7) authorizes a special attribute reduction ordering rule applicable only to S corporations.

Witzel. In *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), the Seventh Circuit also rejected the analysis in *Nelson* and agreed with the Tenth Circuit's conclusion in *Gitlitz* that excluded COD income passed through to an S corporation's shareholders under Section 1366(a)(1)(A). Furthermore, the Seventh Circuit concluded that a shareholder is entitled to a basis increase for the excluded COD income under Section 1367(a). However, the Seventh Circuit also concluded that any suspended losses of the shareholder must be reduced by the amount of the excluded COD income under Section 108(b). The Seventh Circuit did not expressly indicate how this attribute

reduction occurs, but its decision can be rationalized if the suspended losses were reduced as part of the calculation of taxable income for the year of discharge, although the reduction of losses did not prevent a basis increase.

Farley. The Third Circuit, in *Farley*, was the first court to hold for the taxpayer. The Third Circuit applied the literal language of the Code, concluding that COD income is tax-exempt income that passes through to the S corporation's shareholders under Section 1366(a), resulting in a basis increase under Section 1367. This basis increase permitted the shareholders of the S corporation to utilize losses that had previously been suspended under Section 1366(d). Because Section 108(b)(4)(A) provides that attribute reduction does not occur until the commencement of the following taxable year, the suspended losses could not be reduced under Section 108(b) because they had been fully utilized during the year of the discharge. The court rejected all of the IRS' arguments because the statute clearly and unambiguously provided for the result claimed by the taxpayer.

Pugh. In *Pugh*, the Eleventh Circuit generally followed the approach taken by the Third Circuit in *Farley*. The Eleventh Circuit expressly held that excluded COD income passes through to the shareholders of the S corporation, resulting in a basis increase under Section 1367. Because the shareholders in *Pugh* had no suspended losses, attribute reduction was not an issue. The Eleventh Circuit emphasized that while Congress may not have intended this result, it was clear under the statute, and the Eleventh Circuit was leaving the re-writing of the Code to Congress.

Gaudiano. In *Gaudiano v. Commissioner,* No. 99-1294, 2000 U.S. App. LEXIS 12490 (6th Cir. 2000), the Sixth Circuit also concluded that excluded COD income passes through to the shareholders of an S corporation (thereby rejecting *Nelson)* and focused on the timing of attribute reduction. The court believed that there was a conflict between Sections 108(d)(7) and 108(b)(4)(A), resulting in a "close call" as to the timing of attribute reduction. The court was concerned that if attribute reduction occurs after the COD income passes through, then there might be no attributes left to reduce. The court further argued that although Section 108(b)(4)(A) provides that the reduction in tax attributes shall be made after the determination of the tax imposed for the taxable year of discharge, it did not prevent the reduction of some attributes in the year of discharge. As a result, the court concluded that suspended losses must offset any COD income, with any excess COD income passing through to the shareholder as a basis increase. The losses claimed by the taxpayer in the year at issue were denied, but losses would be possible in the future to the extent that excluded COD income exceeded current suspended losses.

ARGUMENT

1. TAX ATTRIBUTES OFFSET INCOME FOR THE YEAR OF THE DISCHARGE BEFORE SUCH ATTRIBUTES ARE REDUCED UNDER SECTION 108(b)

A. Tax Attribute Reduction is the Only "Cost" of the Exclusion for COD Income by an S Corporation

Section 108(a) provides for the exclusion of COD income by insolvent or bankrupt taxpayers. In the case of

an S corporation, this determination is made at the corporate level, *i.e.*, COD income is excludible if the S corporation (rather than its shareholders) is bankrupt or insolvent. The exclusion for COD income is not elective.

The Code exacts a price for the exclusion of COD income through attribute reduction under Section 108(b). Of course, attribute reduction occurs only if the taxpayer has any attributes to reduce. If an insolvent or bankrupt taxpayer has no tax attributes, the COD income is excluded under Section 108(a) but Section 108(b) has no impact.[12] In other words, COD income is always excluded by a bankrupt or insolvent taxpayer; the only "cost" to the taxpayer is attribute reduction, if the taxpayer has any tax attributes at the time the reduction occurs.

B. The Timing of Tax Attribute Reduction is Determined under Section 108(b)(4)(A)

As important as the conclusion that tax attributes are reduced is *when* such reduction occurs. Section 108(b)(4)(A) provides that tax attribute reduction occurs

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[12] The IRS argued in several of the cases below that Section 108(a) provides for a deferral, rather than an exclusion, of COD income because of tax attribute reduction under Section 108(b). That argument fails to take into account the situations in which a taxpayer has no tax attributes; in that case, there is no deferral, only exclusion. Furthermore, the IRS' argument ignores the word "could" in Section 1366(a)(1)(A); depending upon the circumstances of the shareholder, the excluded COD income *could* affect the determination of the shareholder's tax liability. The IRS conceded in *Farley* that the excluded COD income could be tax-exempt income. *See* 202 F.3d at 210.

"after the determination of the tax imposed by this chapter for the taxable year of the discharge." This plainly means that attributes are not reduced until after all of the tax consequences for the year of the discharge have been determined and taken into account. Thus, as a practical matter, tax attribute reduction occurs as of the first moment of the taxable year following the year of the discharge. This rule permits a taxpayer who has excluded COD income to utilize tax attributes to reduce his or her tax liability for the current taxable year (and, to the extent permitted under Section 172, to carry back any losses to prior taxable years) before such attributes are eliminated.

Two examples help illustrate this point. First, assume that an individual, Andy, owns an office building as a sole proprietor. Andy borrows $20,000 from a bank to meet the cash flow needs of his building and promptly spends (and deducts) all of the money, resulting in an NOL of $20,000. Andy is hopelessly insolvent because of other debts, and to avoid a useless collection action, the bank agrees in 2001 to discharge the debt. Simultaneously, to support himself, Andy gets a job as a waiter, earning $15,000 in 2001. The application of Section 108 is clear in Andy's situation. The COD income of $20,000 is excluded under Section 108(a). Andy uses the NOL of $20,000 to offset his salary income, which otherwise would have been taxable income for the year of discharge. After Andy's tax liability for the taxable year of the discharge has been determined, the remaining NOLs ($5,000) are eliminated under Section 108(b).

The same analysis would apply if the taxpayer were a C corporation. Assume that Bigco, which is involved in real estate development, borrows $100 million to finance

an office project. Bigco incurs large losses from depreciation and interest, resulting in $13 million of NOLs. The following year, Bigco provides leasing and management services to other companies, earning fees of $11 million, but because of its debt, Bigco is hopelessly insolvent, causing the lender to forgive $15 million of the loan. The tax consequences are clear: Bigco would exclude the COD income, and Bigco could use $11 million of NOLs to offset its services income. The remaining $2 million of NOLs would be eliminated under Section 108(b). If Bigco had any other tax attributes (such as basis in property, provided that the debt that encumbers the property does not exceed the amount of such basis), such other attributes would then be reduced.

The timing of tax attribute reduction is an important facet of the statutory scheme that applies to all taxpayers. Congress wanted to make certain that bankrupt or insolvent taxpayers could fully utilize their tax attributes to offset any income for the year of the discharge. Without this provision, an insolvent or bankrupt taxpayer could owe income tax that the taxpayer lacked the financial resources to pay. The ordering rule in Section 108(b)(4)(A) promotes the "fresh start" policy that underpins the income exclusion in Section 108 by allowing the insolvent or bankrupt taxpayer to utilize tax attributes to fullest extent possible before reducing them under Section 108(b).[13] Congress consciously allowed taxpayers to

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[13] *See* The Bankruptcy Tax Act of 1980: Hearings Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Statement of Daniel I. Halerin, Deputy Assistant Secretary of the Treasury for Tax Legislation, 96th Cong., 1st Sess. 3 (Sept. 27, 1979). Mr. Halperin stated that:

utilize their tax attributes to the maximum extent possible before reducing them as a result of the exclusion of COD income.

C. The Sixth, Seventh and Tenth Circuits Erroneously Interpreted or Ignored Section 108(b)(4)(A)

The fundamental flaw in the circuit courts' decisions in *Gitlitz*, *Witzel* and *Gaudiano* is the disregard of the ordering rule in Section 108(b)(4)(A). All these courts concluded that COD income of an insolvent or bankrupt S corporation that is exempt under Section 108(a) flows through to the corporation's shareholders, as required by Section 1366(a)(1)(A). However, the courts apparently did not want to allow the taxpayer to obtain all of the benefit of the basis increase that Section 1367(a) requires. Accordingly, the courts mandated attribute reduction by altering or ignoring the ordering rule in Section 108(b)(4)(A).[14]

> We are sympathetic to the basic policy of bankruptcy and would not want to discourage creditors from forgiving part of a debtor's debt by creating a tax liability that might be collectible before the amounts owing to forgiving creditors. Accordingly, we agree with the position taken in [the Bankruptcy Tax Act of 1980] that no taxpayer in bankruptcy, and no taxpayer who is insolvent after a debt is forgiven, should incur a tax liability as a result of forgiveness of indebtedness.

[14] The courts were not completely clear in how this attribute reduction would occur. In *Gitlitz* it appears that the Tenth Circuit used the suspended losses to offset COD income, which does not make any sense because the COD income was excluded by operation of Section 108(a). In *Witzel*, the Seventh

The disregard of Section 108(b)(4)(A) in *Gitlitz*, *Witzel* and *Gaudiano* is the RER's primary concern in this case. The courts that have supported the IRS have all (with the exception of the Tax Court in *Nelson*) issued result-oriented decisions that have misapplied Section 108(b)(4)(A). This creates a significant problem in applying Section 108(b)(4)(A) in the context of debt workouts not involving S corporations.

Every debt workout in which there is attribute reduction involves Section 108(b)(4)(A). This timing rule permits insolvent and bankrupt taxpayers to use their tax attributes in order to avoid having to go even further in debt to pay a tax on their taxable income in the year of the discharge, and also permits the attributes to be carried back to offset income in prior taxable years before reduction under Section 108(b).[15] Any deterioration of this rule will increase the tax burden on debt workouts, making them more difficult to achieve.

Moreover, there is no good argument to the contrary. The Sixth Circuit strained to find a way around the plain meaning of Section 108(b)(4)(A) in *Gaudiano*, arguing that such provision does not preclude the reduction of certain attributes in the year of the discharge. But that argument

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Circuit also agreed to offset the suspended losses against the COD income in order to avoid a "windfall" to the taxpayer. *See* 200 F.3d at 497. The Sixth Circuit was explicit in *Gaudiano*, stating that it was requiring the taxpayer to reduce some of its tax attributes (suspended losses) in the year of the discharge.

[15] Myron Sheinfeld, Fred T. Witt, Jr. and Milton Hyman, *Collier on Bankruptcy Taxation* ¶ TX6.03[2][b] (Matthew Bender, 1999).

completely disregards the word "after." If credence is given to the statute as written, there is no sound argument that attribute reduction occurs at any time other than *after* the taxable year of the discharge, *i.e.*, at the first moment of the succeeding taxable year.

The Sixth Circuit's argument, as well as that of the Tenth Circuit in *Gitlitz*, also ignored Section 1017, which is the provision giving effect to the basis reduction mandated under Section 108(b). Section 1017 clearly states that the attribute reduction is made as of the first moment of the taxable year following the year of discharge of the indebtedness. This provision, which was added to the Code at the same time as Section 108(b)(4)(A), clearly shows that Congress intended attribute reduction to occur *after* the year of discharge.

D. The Third and Eleventh Circuits Correctly Applied Section 108(b)(4)(A)

The circuit courts that held for the taxpayers have correctly held that attribute reduction occurs as of the first moment in the year following the year in which the debt cancellation occurs. As a result, the taxpayers were able to utilize suspended losses before attribute reduction occurred. This may result in a benefit to the taxpayers because suspended losses can be used before they are reduced. But it is a benefit that Congress specifically mandated – tax attributes are reduced only AFTER an insolvent or bankrupt taxpayer has determined its tax liability for the year of discharge.

It must be emphasized that the timing of attribute reduction under Section 108(b)(4)(A) does not always

result in a benefit to the shareholder of an S corporation. If the shareholder's suspended losses exceed the amount of excluded COD income, the shareholder will always suffer a detriment. For example, assume that John owns 100% of the stock of an insolvent S corporation that has borrowed and lost $1 million. As a result of these debt-financed losses, John has suspended losses under Section 1366(d) of $1 million. The lender to the corporation forgives $600,000 of the debt. The $600,000 of COD income will result in a basis increase of $600,000, allowing John to utilize that portion of his suspended losses. His remaining suspended losses ($400,000) would be eliminated, however, due to the attribute reduction that occurs as of the first moment of the succeeding taxable year.[16]

The RER believes, for the reasons set forth below, that the taxpayers should prevail in this case. But no matter how this Court rules in determining the tax consequences of excluded COD income to an S corporation, we urge the Court not to cast doubt upon the vitality of the ordering rule in Section 108(b)(4)(A).

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[16] From a mathematical perspective, (i) there will always be attribute reduction to some extent if the suspended losses of the S corporation shareholder exceed the amount of the debt that is discharged, and (ii) if the suspended losses are at least two times the amount of discharged debt, there will always be a full, dollar-for-dollar attribute reduction. In addition, attribute reduction will have an impact if the S corporation has any other tax attributes, such as basis, that could be reduced.

2. THE TAXPAYERS SHOULD PREVAIL UNDER THE PLAIN MEANING OF THE APPLICABLE STATUTORY PROVISIONS

A. The Applicable Law is Clear

The tax law can be obscure and confusing. In this case, however, the applicable provisions are relatively clear and straight-forward. The Code provides that (i) COD income is excluded by an insolvent or bankrupt S corporation under Section 108(a), (ii) the excluded COD income is an item of income to the shareholders of the S corporation under Section 1366(a)(1)(A) because it could affect the calculation of their tax liability,[17] (iii) all items of income under Section 1366(a)(1)(A) result in a basis increase under Section 1367(a), (iv) the increased basis permits a shareholder to utilize in the year of the discharge any losses that were previously suspended due to the basis limitation in Section 1366(d), and (v) attribute reduction (which could reduce the amount of suspended losses) does not occur until the first moment of the following taxable year under Section 108(b)(4)(A).

These rules are plain and indisputable. There is no ambiguity in the Code. Tax-exempt income includes all COD income, just as it includes all other items of income described in Part III of Subchapter B of Chapter 1 of the Code. Likewise, the pass-through of items of tax-exempt income to the shareholders of an S corporation, and the basis increase for such items of income, is mandated by

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[17] The excluded COD income would, for example, result in attribute reduction to any S corporation shareholder who had suspended losses in excess of the amount of COD income.

the express statutory language. So is the timing of attribute reduction.

If the language of the statute is plain, then the Court is obligated to enforce it according to its terms. *See Caminetti v. U.S.*, 242 U.S. 470 (1917). This fundamental principle of statutory interpretation is at the heart of this case. If this Court concludes that the statutory language is clear – and we believe that it is – the fact that the Code leads to what the IRS believes is not the "right" result is meaningless. If the IRS believes that the result should be different, then the IRS should look to Congress, not to the courts, for recourse.

B. The Applicable Law Has Always Been Clear

What makes this case particularly frustrating is not only that the language of the Code is clear, but also that taxpayers and their creditors knew what the Code said and what it meant and applied it on that basis. Numerous commentators have considered how these provisions work, and they have nearly universally reached the same conclusion – the law clearly supports the taxpayers' position.[18] Likewise, in the early 1990s, in connection with the

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[18] Commentaries that stated tax attribute reductions are to be made in the year following discharge include: Sheinfeld, Witt & Hyman, *supra* note 15, ¶ 6.03[4][b][i], at 6-103; Bryan P. Collins & Mark A. Schneider, *"TAM 9423007: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis,"* 6 J.S. Corporation Tax'n 348 (Spring 1995); Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders – The Tenth Circuit Gets Lost in Gitlitz*, 91 J. Tax'n 197 (October 1999); James D. Lockhart and James E. Duffy, *Tax Court Rules In Nelson That S*

debt workouts that were sweeping the country, the American Bar Association Section of Taxation formed a task force to describe current law concerning debt workouts and, where necessary, provide guidance concerning the possible application of the law where it was not clear. The ABA Task Force Report concluded that the applicable law was clear, while indicating that a minority of the members of the Task Force believed that a legislative change was appropriate.[19] This report was submitted to the IRS in July 1992.

Moreover, Congress was aware of the interaction of these provisions of the Code. This is proven by the legislative history to Section 108(a)(1)(D), which was enacted in 1993.[20] This provision allows the exclusion of COD income with respect to qualified real property indebtedness. Congress was concerned that such COD income could result in a basis increase for S corporations under the plain language of the Code. To prevent this result, the legislative history to the 1993 Act expressly provides that

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Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 25 Wm. Mitchell L. Rev. 287, 310 (1999); Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. Tax Rev. 1, 46-47 (1990). Commentaries that stated tax attribute reductions are to be made in the year of discharge include: C. Richard McQueen and Jack F. Williams, *Tax Aspects of Bankruptcy Law and Practice* § 25:6, at 25-6 (3d ed. 1997).

[19] Fred T. Witt, Jr., *Report of the Section 108 Real Estate and Partnership Task Force*, 46 Tax Law. 209, 234-35 (1992). This report was published before any of the cases at issue were decided, as well as before the enactment of Section 108(a)(1)(D), discussed below.

[20] Revenue Reconciliation Act of 1993 (the "1993 Act").

there is no basis increase in an S corporation for COD income from qualified real property business indebtedness. However, Congress enacted this special rule for qualified real property business indebtedness, and no change was made to the treatment of COD income of an insolvent or bankrupt S corporation. As the Third Circuit recognized in *Farley*, the 1993 Act does not support the IRS' position that excluded COD income does not affect the basis in the stock of an S corporation. Indeed, because Congress failed to change the applicable provisions in Sections 108, 1366 and 1367 of the Code, it could be inferred that Congress was endorsing the long-standing interpretation of these provisions while requiring a different result for COD income relating to real property business indebtedness.[21]

The clear statutory language results in a basis increase for excluded COD income by an insolvent or bankrupt S corporation. The result could be viewed as an appropriate tax benefit for the shareholder of an insolvent corporation, or it could be viewed as an untoward benefit to the shareholders of an insolvent S corporation. No matter which result is viewed as "right," however, the law remains clear.

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[21] "Where Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least in so far as it affects the new statute." *Lindahl v. Office of Personnel Management*, 470 U.S. 768, 783 (1985).

C. The Courts Have Disregarded Clear Law to Hold for the IRS

Each court that has found in favor of the IRS in this case has had to disregard or ignore the plain meaning of the statute in order to do so. The Tax Court did this in *Nelson* when it concluded that COD income does not pass through to the shareholders of an S corporation, notwithstanding the clear language to such effect in Section 1366(a)(1)(A). No circuit court has agreed with this analysis – even the three circuit courts that have held for the IRS have rejected the Tax Court's interpretation of Section 1366(a)(1)(A). The *Nelson* decision is difficult to support because the exclusion for COD income under Section 108 is worded exactly the same as the exclusion for other items of gross income under Part III of Subchapter B of Chapter 1 of the Code, which the IRS agrees result in a basis increase for an S corporation shareholder.[22] There is no statutory support for treating COD income different than other items of tax-exempt income.

Moreover, as discussed in detail above, the three circuits that have held for the IRS have erroneously applied Section 108(b)(4)(A) in order to reduce tax attributes. Once these courts concluded that COD income is an item of tax-exempt income that flows through to the shareholders of an insolvent S corporation, the application of the rules became automatic and irrefutable: (a) the shareholders' basis is increased by the COD income, (b)

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[22] Each section in Part III of Subchapter B of Chapter 1 of the Code, including Section 108, begins with the language "Except as otherwise provided, gross income does not include . . . "

the basis increase permits the utilization of losses previously suspended under Section 1366(d), and (c) any remaining tax attributes are reduced as of the first moment of the following taxable year. The Sixth, Seventh and Tenth Circuits attempted to avoid this result by requiring tax attribute reduction, even though the Code provides no support for their position.

D. *Farley* and *Pugh* Correctly Applied the Clear Law

The Third and Eleventh Circuits did not labor under the burdens facing the courts that wanted to hold for the IRS. In *Farley* and *Pugh*, the circuit courts simply enforced the statute as they found it.

Both circuit courts recognized that the result was beneficial to the taxpayer; some persons have even called the result a "windfall."[23] Whether or not this result should be viewed as a windful is debatable.[24] On the

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[23] Commentaries that have not viewed the basis increase and utilization of suspended losses as a windfall include: Richard M. Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income on S Corporations*, 92 J. Tax'n 207 (April 2000); Sheinfeld, Witt & Hyman, *supra* note 15, ¶ 6.03[4][b][i], at 6-103. Commentaries that have viewed the basis increase and utilization of suspended losses as a windfall include: McQueen, *supra* note 18.

[24] The taxpayers' position essentially results in allowing the taxpayer to utilize debt-financed deductions without any obligation to pay back the indebtedness. This result also occurs every time an individual taxpayer borrows money, uses debt-financed losses to offset his/her taxable income from other sources, and then fails to pay back the debt due to insolvency or

other hand, the tax benefit is obtained only because there has been a substantial economic loss, as reflected by the insolvency or bankruptcy of the S corporation. Thus, the supposed tax benefit is available only if the shareholder has suffered a large economic loss. This is the type of rational determination that Congress could have made (although there is no meaningful legislative history concerning Congress' intent in enacting these rules).

The RER does not believe that it is useful or worthwhile in this case to get into a debate concerning what is a "right" or "wrong" result in this situation, because there are arguments on both sides of the coin. What the RER believes is indisputable, however, is that the applicable law is clear. As discussed above, there is no way to interpret the statutory provisions other than (i) COD income of an insolvent or bankrupt S corporation is exempt under Section 108(a), (ii) the exempt COD income passes through to the shareholders of the S corporation under Section 1366(a)(1)(A), (iii) the shareholder's stock basis is increased under Section 1367(a) by all items described in Section 1366(a)(1)(A), (iv) the basis increase allows the shareholder to use losses that previously were suspended under Section 1366(d), and (v) although the suspended losses are treated as NOLs for purposes of applying the attribute reduction rules in Section 108(b), such attribute reduction does not occur until the first moment of the following taxable year under Section 108(b)(4)(A).

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bankruptcy. Thus, it is far from clear that there is a windfall when this benefit is available in the S corporation context, because S corporations have individual shareholders.

E. The Tax Law Requires Certainty

Taxation is one of the few areas of the law that affects almost every person in the United States. Every individual, and every business, must comply with the tax law. Creditors and taxpayers alike require certainty in the context of a debt workout or bankruptcy. And the tax laws are very complex.

Compliance with the tax law is a major concern in the real estate industry. Moreover, there are many provisions of the tax law that provide beneficial treatment to real estate.[25] Needless to say, it would be difficult for the real estate industry to plan for the tax consequences of their transactions if the clear result under the Code could be undermined because the IRS did not like the answer.

This case clearly illustrates the problem. As discussed above, the rules concerning the tax treatment of COD income by insolvent S corporations are clear, and the result has been known (and widely publicized) for many years. This is about as "certain" as one can get in the tax arena. This type of certainty should be furthered, not undercut, by the courts.

F. Application of the Plain Meaning of the Code Requires a Decision for the Taxpayers

The rules of statutory construction obligate this Court to apply the plain meaning of the statute, and not to resort to trying to determine what is the "right" or

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[25] *See, e.g.*, Section 1031, Section 121, Section 25, Section 42, Section 856, Section 857.

"wrong" answer, when the statutory provisions are clear. As the Third and Eleventh Circuits have recognized, the plain meaning of the statute results in a decision for the taxpayers in this situation. The result may not be pretty – the taxpayers get a benefit that Congress may or may not have intended – but it is clearly the result under the statutory language. The tax benefit arises, however, because of an economic loss that the taxpayer has suffered. Any other result runs contrary to long-standing rules of statutory construction and should be avoided by this Court.

CONCLUSION

Wherefore, the RER prays that this Court issue a decision reversing the decision of the Tenth Circuit in *Gitlitz* and requiring that decision be entered in favor of the taxpayers for the reasons set forth by the Third Circuit and the Eleventh Circuit in *Farley* and *Pugh*, respectively.

Respectfully submitted,

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